ESG Disclosure Practices in Europe

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The increased focus on environmental (E), social (S), and governance (G) (ESG) disclosure has become a necessary step toward the integration of sustainability practices into firms' culture to meet the expectations of stakeholders. Both board CSR orientation and strategy and the GRI have positively and significantly affected the overall disclosure of ESG practices within Europe.

Keywords: ESG disclosure ; Europe ; environmental ; social ; governance

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1. ESG Disclosure

The term 'nvironmental (E), social (S), and governance (G) (ESG)' was introduced in 2004 in 'Who Cares Wins' and was introduced to find ways to incorporate the aspects of ESG into the capital market [1]. From this point on, ESG is seen as an extension of traditional CSR and socially responsible investment (SRI) [2][3]. The growing public awareness of corporate recognition of actions toward the planet has led to this increase in the implementation of sustainability strategies. Within this, an increasing number of firms have now revealed their ESG information to the public [4]. The concern around ESG issues has grown into the realm of climate change, concern over poor working conditions such as safety violations, etc. [5]. Interest in ESG is also seen from the corporate perspective, identified by the Governance and Accountability Institute. For example, in their 2018 report, the institute found that 86% of the S&P 500 companies released sustainability reports [6]. These figures reflect the increase in sustainability reporting growth and how disclosure of ESG has become a tool for communicating sustainability activities [7][8]. This increase in the number of standalone sustainability reports published and/or CSR sections in annual reports is not only seen by investors and corporate management [6]; Helfaya and Whittington note that disclosure of ESG is desirable both from a private and public perspective. From a theoretical point of view, the link between the integration of the ESG strategy and cultural values can be seen [9]. Toumi et al. note that the cultural system within the country has effects on managerial decision-making processes [10]. This is further examined by Baldini et al. note that culture affects voluntary and mandatory disclosure of sustainability information [11]. Ioannoi and Serafeim note that within countries operating with a low level of social cohesion and unequal distribution of opportunities, managers feel a greater obligation to stakeholders to enforce firms to disclose more non-financial information through the ESG reporting system [8]. There are motivations behind reporting on ESG practices, within the capital markets; such disclosure is seen as an effective risk management tool [2].

Disclosure of ESG has become increasingly important for the reputation, brand image, and investment decision-making of a firm [12]. The ESG activities of a firm are considered crucial to institutional and individual investors, as disclosure of ESG serves the opportunities and risks faced by the firm. For example, Ellili's study states that investors now use ESG information to decide whether to invest in a firm or not. Consequently, ESG disclosure plays an important role in the growing need to satisfy investors' demands for non-financial information and corporate compliance, such as the GRI sustainability reporting framework [13]. The interplay between firm-level and country-level attributes is also significant within ESG disclosure performance. For example, Schiehll et al. found that cross-national governance has equated governance effectiveness with shareholder wealth. Within other cross-country literature [14], the research found that investor protection from the firm ownership structure is important for higher levels of governance within firms. The overall governance of the firm is highly influenced by voluntary codes, relationships, and the social norms seen in the country headquarters that establish the president for the internal governance systems in place [14]. In fact, there are several sustainability reporting frameworks, such as GRI and the International Integrated Reporting Council (IIRC) framework that cover ESG; these frameworks aim to provide reliable reporting guidelines that create comparability between firms [15]. However, the production of reports means that an effective corporate governance system must be in place. These build trust with end users of this information that fosters innovation in the capital market through the achievement of sustainable financial performance [16]. The overall objective of the disclosure of ESG used as a sustainable development mechanism is to create a long-term solution to the needs of society and protect the ecosystem [17]. Within the global sustainability agenda, the mitigation of climate change and the social shift to social and governance factors have become permanent characteristics of investors [18]. Furthermore, the 'Triple Bottom Line' model aims to protect and sustain society and the environment for future generations by achieving positive *profit*, making *people* happy and protecting the *planet* (i.e., 3Ps). This also involves maximizing the objective of market capitalization [19]. The focus on sustainability strategy means that it must be financially secure to create long-term value from reducing environmental impact through product innovation and activities to create a strategy that creates a competitive advantage. In summary, disclosure of ESG is considered necessary to create sustainable growth and provide market metrics for investment decisions [17].

2. Factors Affecting the ESG Disclosure Practices in Europe

Research on ESG disclosure has increased significantly in recent years with a multiple theoretical framework underpinning research such as agency, stakeholder, signaling, institutional, and legitimacy theory. Agency theory stresses the existence of agency problems and information asymmetry between principals (i.e., shareholders) and agents (i.e., managers) [4]. According to agency theory, the principal delegates management power to the agent, who should be in the best interest of the principal, but usually pursues his objectives to determine the interests of the principal [20], while stakeholder theory suggests that all actors of the firm should be accountable to shareholders and other stakeholders [21]. Moreover, signaling theory is concerned with market signals to address information asymmetry, which increases the likelihood of informed decisions between two parties. Scott and Meyer suggest that there are organizational practices adopted because they correspond to institutionalized expectations that are not under firm control. This is closely related to the theory of legitimacy, as firms constantly seek to ensure that they operate within the limits of social norms [22].

Second, stakeholder theory focuses on the need to manage stakeholder expectations, which have the power to provide firms with the required resources (e.g., financial, manufacturing, social, human, and environmental capitals) which are essential to ensure the going concern of the business [23]. Stakeholder theory promotes the use of an internal management tool which focuses on strategies towards non-financial goals such as seeking to improve social welfare and surrounding environments. Such value-maximizing governance practices can incorporate shareholder values due to good management practices [24][25].

Third, signaling theory is concerned with reducing information asymmetry. With this, the increase in communication channels increases the information available between the company and the users, thus reducing the information asymmetry [25]. The end user of this information chooses how to interpret the information, the signal sent by the company [26]. ESG disclosure information is used as a tool to provide voluntary information on sustainability efforts and disclosure of ESG performance indicators [27]. Flynn and Thorton argued that signaling theory suggests that voluntary disclosure decisions lead to value-related information on ESG performance. This voluntary nonfinancial disclosure helps investors predict economic earnings; therefore, firms use it to signal their sustainability achievements, legitimize their existence, and maintain or regain their corporate reputation [28][29].

Fourth, institutional theory is a frequently adopted framework in the literature on ESG, since disclosure of ESG plays an important role in portraying the reputation of corporate sustainability [30]. Therefore, institutional theory reflects the impact of social and environmental performance on corporate success [31]. Campbell notes that within the institutional theory paradigm, companies are perceived as economic units operating within such frameworks constructed by institutions with expectations [30]. Firms that operate in countries with similar institutional structures tend to adopt similar behavior forms, such as ethical behavior. Scott considers ethical behavior a normative institution, as it includes informal rules associated with morals and values [32].

Finally, from a legitimacy perspective, corporate legitimacy is gained by releasing more useful information on ESG that helps stakeholders assess the impact of their companies on society and the environment [28]. Reber et al. found that sustainability reporting is a key form of corporate communication that companies engage in with their strategic objective, thus increasing the legitimacy of the firm [33]. Using ESG reporting, organizations show the public their compliance with societal norms [34]. Therefore, legitimacy theory is an important motivator for companies to disclose more ESG information to legitimize their existence and achieve sustainable growth through the social acceptance of their communities [34]. This disclosure of ESG can be used to convince societies that companies are working in accordance with their social norms to meet their expectations [35].

2.1. Board CSR Orientation

Board CSR orientation is known as corporate directors' acknowledgement of the importance of the environmental concerns facing their companies [28]. Helfaya and Moussa found that board CSR orientation enhances sustainability activities and the performance of companies [28]. Previous studies suggest that corporate board characteristics may be present among directors who have a positive impact on firm ESG disclosure practices, such as board independence, gender diversity, and the presence of at least one financial expert in the audit committee [28][34].

Board Independence—From an agency perspective, Fama and Jensen state that boards should consist of a greater proportion of non-executive directors (NEDs) to aid in decision-making as well as an increased level of monitoring potential conflicts of interest between managers and shareholders [36]. In fact, corporate executives have the ability and potential to be more attentive to short- and medium-term financial goals, while NEDs may feel that social and environmental issues are as important as profit maximization [36]. The presence of NEDs in boardrooms helps challenge decision-making, bringing different stakeholder perspectives [37]. Similarly, from the stakeholder perspective, greater board independence means that there are NEDs on the board who encourage management activities to maximize long-term value and higher levels of transparency [38]. Regarding ESG disclosure practices, previous literature has found that board independence plays a crucial role in mediating and promoting ESG disclosure practices to enhance transparency and build trust with stakeholders [39][40]. Similarly, Cuccari states that the more NEDs in the boardroom, the more investments in sustainability activities [38]. Both legitimacy and signaling theories support the debate that NEDs are very interested in considering the CSR activities and performance of their firms and, therefore, that they are disclosing more information about ESG to carry out their social and environmental responsibility to stakeholders [28][41].

Board Gender Diversity—Boardroom gender diversity is increasingly recognized within the ESG and sustainability agenda. The role women play in corporate boardrooms is multifaceted [28]. First, according to the literature on board gender diversity, male directors are likely to be characterized by agentic attributes, while female directors have more communal characteristics [42]. In practical terms, women are concerned with the welfare of the entire society rather than shareholders; thus, women directors address the interests of all stakeholders. Therefore, having more women on board affects the business agenda of their companies concerning social and environmental issues [43]. Second, compared to male directors, female directors have different experiences, as female directors tend to gain board experience with smaller firms [44]. This experience and diverse business background lead to contributing to the sustainability strategy and activities of their companies [45]. The presence of a female on board is also related to legitimacy, signaling, and institutional theory, as the presence is generally perceived as a signal of compliance with expectations of society, governance regulations, and capital markets requirements [45].

The presence of financial expert in the Audit Committee—Iyer et al. define the presence of a financial expert in the audit committee as a director having an accounting or auditing background or any relevant financial experience [46]. It is argued that the efficiency of the audit committee is enhanced by the presence of at least one financial expert, as it ensures the effective operations of the audit committee and increases the effective monitoring of all financial matters [46]. In reality, boardroom directors with financial experience and qualifications will challenge managers and accounting and finance teams to comply fully with accounting standards and financial regulations to improve the credibility of all accounting records, including corporate reports [46]. In the same way as enhancing the credibility of corporate financial reporting, they will also consider other non-financial matters, including CSR reporting [47]. Previous empirical studies have shown a positive relationship between the presence of at least one financial expert on the audit committee and ESG disclosure scores [46]. According to both stakeholder and legitimacy theories, the presence of the financial expert in the audit committee will improve the quality of CSR disclosure practice [46]. In the same vein, the agency theory suggests that members with financial experience and qualifications will work to improve the ability of the audit committee to evaluate the judgments of auditors, and this can be an instrumental tool in controlling risk management, etc. [46].

2.2. Board CSR Strategy

Board CSR strategy is defined by Banerjee, [48] (p. 106), as ‘the extent to which environmental issues are integrated into a firm’s strategic plans’. Firms should adopt an effective board CSR strategy to achieve their long-term strategic and sustainable business goals. Isaksson and Steimle provide evidence that companies with effective CSR strategies have better sustainability performance [49]. These results are also mirrored by the Helfaya and Moussa study which finds a positive association between effective board CSR strategies and corporate sustainability practices [28]. An effective CSR strategy on the board leads to better sustainability performance [28]. In relation to the theoretical framework, board CSR strategy has close ties to legitimacy theory as the presence of the board CSR strategy will help the corporate boardrooms to set and achieve their long-term goals and renew their licenses to operate [50]. This decision for a CSR strategy establishes a strategy to enhance the relationship between an organization and its stakeholders with which it operates according to stakeholder theory and legitimacy theory [51].

2.3. Global Reporting Initiative

The GRI framework is for non-financial reporting that covers aspects of ESG reporting and performance. The GRI guidelines were initially published in 2000, to support companies in creating sustainability reports that present the impacts of business operations and activities on society and the environment [52]. The GRI is a voluntary sustainability reporting framework for organizations to prepare their sustainability reports [53]. Previous research indicates that the adoption of GRI sustainability reporting guidelines is on the rise and likely to increase despite current methodological difficulties and information gaps based on its voluntary reporting basis [53][54]. Based on the perspective of legitimacy theory, companies will legitimize their existence by following the GRI sustainability reporting guidelines to communicate their sustainability activities and performance, such as fighting climate change, respecting human and labor rights, fighting corruption, etc., to the public [55]. Similarly, according to signaling theory, companies can use GRI as an effective management tool to signal their commitment to long-term sustainability policies to meet the expectations of their stakeholders. Furthermore, such sustainable disclosure practices signal to stakeholders and society the strong corporate governance practices that are implemented that provide strong transparency, achieve long-term financial and non-financial goals, and improve the overall participation of stakeholders [49].

2.4. Country–Cultural Dimensions

Muttakin (p. 23) defines culture as ‘the collective programming of the mind that distinguishes the members of one human ground from those of another’ [56]. The author stated that these cultural dimensions such as the power distance index, individualism versus collectivism, uncertainty avoidance, masculinity versus femininity, long-term orientation versus short-term orientation, and indulgence versus restraint are integrated into consumer practices and corporate governance [56].

Individualism and collectivism—Individualism versus collectivism is related to the degree of independence among people in a society where society is seen as loosely knit and concerned with themselves and the immediate family [57]. Collectivism, in contrast, emphasizes the importance of community and community interest over individual interests and is expected to place the community first [57]. Shin et al. state that countries with higher collectivism, ESG practices are more likely to be embedded in society's obligations [58]. However, an individualism culture receives greater financial gains from disclosing ESG information.

Masculinity and Femininity—Raimo et al. note that masculinity reflects a culture where there are dominant values present such as material goods and success [59]. In contrast, a feminine society reflects a more caring view and harmonization of the values and norms of others. At the firm level, masculine societies consider maximizing profits as social norm compared to feminine societies that focus on society members [59]. A feminine society may see the disclosure of ESG as an obligation to society; therefore, creates less incentive toward the disclosure of ESG as it is to maintain legitimacy rather than to create it [58]. Compared to a masculine society, ESG information is seen as a competitive advantage because the focus is placed on profit maximization for most firms. Shin et al.'s research found that masculine societies exhibit a stronger relationship between ESG performance and financial performance due to the competitive advantage seen by masculine cultures focusing on ESG disclosure cultures characterized by masculinity; thus, they are less likely to perceive ethical transgressions in business transactions, and this tolerance of unethical behavior creates conditions that are conducive to widespread corruption [60]. According to the adopted theoretical framework, institutional theory, for example, considers ESG disclosure practice as an institutional factor that focuses on the role of social beliefs, values relations, and expectations constraints [60]. This argues that corporations are embedded in a nexus of formal and informal rules [61]. The dimensions of the country–culture are based on Hofstede's constructs and represent a proxy for the deeper aspects of culture related to differences in institutional functioning. Within a femininity culture, the stakeholder perspective is characterized as femininity representing the social needs and harmonization of stakeholders at a holistic level.

Uncertainty avoidance low and high—Hofstede refers to uncertainty avoidance as 'the extent to which members of a culture feel threatened by uncertain or unknown situations' (p. 46). Uncertainty avoidance deals with the tolerance of people for ambiguity and uncertainty. There is a strong positive correlation between a risk-taking attitude (i.e., uncertainty accepting behaviour) and unethical actions [62]. Singhapakdi's article concludes that there is a strong positive correlation between the attitude of people towards risk and unethical actions [61]. Uncertainty avoidant societies mean that risk-taking is discouraged and societies are likely to have an increased demand for information. Countries with high uncertainty avoidance, such as Japan, prefer a structured environment such as a clear hierarchy, strict laws, and rules to minimize uncertainty. Therefore, a higher level of information on ESG is significantly associated with cultures characterized by a greater power distance (i.e., less likely to tolerate questionable business practices [63]. Within the theoretical framework adopted and the underpinning of uncertainty avoidance high and low, the institutional perspective is based on Hofstede's cross-country–cultural dimensions to successfully be perceived as legitimate actors [64].

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