Nexus between Sustainability Reporting and Firm Performance

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The relationship between Sustainability Reporting and corporate financial performance is overlapping and multifaceted and it has been an interesting issue for both academics and professionals since the beginning of the millennium.

Keywords: sustainability reporting ; financial performance ; sustainability impact

1. Introduction

Sustainability reporting (SR) is one of the prominent research areas which has received exponentially increasing attention in recent years. SR covers environmental, social, and governance (ESG) issues and sustainability concerns that stakeholders demand from organizations to manage their risks and opportunities. To ensure accountability and transparency, there is a tendency to create a new global system for SR. In 2021 and 2022, tremendous advances have been realized concerning regulations and standards. In November 2021, the IFRS (International Financial Reporting Standards) Foundation Trustees released the establishment of the International Sustainability Standards Board (ISSB) to prepare a global sustainability-related standard. Meanwhile, the European Council in December 2022 accepted the Corporate Sustainability Reporting Directive (CSRD) which generated the release of European Sustainability Reporting Standards (ESRS) by the European Financial Reporting Advisory Group (EFRAG). The latter means that approximately 50,000 companies must disclose data according to ESRS, which will start applying between 2024 and 2028. With this fast evolution of the SR landscape, it is expected that this prevalently discussed topic will continue to be discussed as it has no consistent conclusions about its impact on corporate financial performance [1].

Sustainable reporting can be defined as the measurement, disclosure, and accountability of organizational performance in achieving sustainable development goals to internal and external stakeholders [2]. Thus, SR can reduce the information asymmetry and increase the transparency of the company's sustainability activities and incite investors to direct their investments to companies with positive impacts. Moreover, SR gives a competitive advantage to the companies, in their market or industry [3]. Considering these advantages, companies try to profit from SR and publish their reports. However, the studies in the field also report an insignificant or inverse relationship between SR and financial performance. So, some studies report an increased financial performance [4][5][6][7], albeit others state an inverse [8][9] or an inconclusive relationship between them [10][11][12]. Ref. [13] affirmed on the impact of SR on financial performance that most of the studies pointed to a positive relationship between SR and financial performance. However, due to the mixed results, ref. [13] also recommended further research may yield more consistent findings. Thus, researchers have noticed that consequent to these different findings, sectoral analysis is scarce in SR [14][15]. Indeed, as the ESG factors vary from one sector to the other, analyzing the relationship between SR and financial performance without categorizing the sectors may be the reason behind these mixed results [16][17]. So, these studies with these divergent results lack a sectorial approach to sustainability reporting [18]. The sectorial differences, the development stage of the market in the study, and the measurement choices shape the impact of SR. Although many studies have considered the impact of SR from a holistic point of view [14], scant attention has been paid to sectorial differences on this topic.

2. SR and ESG

The terms SR and ESG are used interchangeably and in an overlapping manner in the literature [19]. Some studies assess the link between financial performance and ESG factors [20], and some others fulfill this aim by using sustainability reports [21][22]. However, this is not entirely accurate. It must be emphasized that SR refers to the information that companies provide about their performance to the outside world on a regular basis in a structured way. Through sustainability reporting, companies communicate their performance and impact on a wide range of sustainability topics, spanning environmental, social, and governance parameters. ESG reports on the other side are reporting frameworks, disclosing environmental, social, and corporate governance data and they can be included in the Sustainability Reports.

According to the stakeholder theory, companies need to fulfill the expectations of diverse stakeholders, not only by disclosing financial, but also non-financial information. Hence, SR by providing transparency and accountability enables stakeholders to make informed and conscious decisions. In the meantime, organizations can identify where they are not meeting societal expectations and can take steps to solve these issues, which are in line with the legitimacy theory [23] and the stakeholder theory [24][25]. Therefore, from the perspective of stakeholder theory, companies can highlight their reputation, gain the support of the stakeholders, and attract investments, which lead to better financial performance [26][27][28]. The demonstration of the commitment to sustainability and building trust with stakeholders and thus, with society, will affect the financial success in the long term and create value, as legitimacy is vital for the long-run prosperity of the company [29][30].

In this line of research, mixed results are obtained based on accounting measures as well as market measures. Return on Assets (ROA) is widely used in numerous studies to measure the accounting aspects, and their relationship with SR disclosed, respectively, a positive relationship in some studies [31][32][33], a negative in some others [34], or insignificance [35][36]. Market performance is measured in many others with Tobins' Q [37][38][39][40] to assure the accountability and transparency of the firm value. **Table 1** resumes the recent studies about SR and firm performance.

Table 1. Recent literature review of SR, ESG factors, and financial performance.

Article	Subject	Focus	Model Used	Results
Mattera et al., 2022 [41]	**Implementation of sustainable business models and its effect on firm's performance**	**FTSEMIB Index Companies' financial performance during COVID-19 in the year 2020**	**Chi-square and correlation analyses of the share price**	**Positive association between sustainable strategies and firm's financial performance**
Oware, K.M., Mallikarjunappa, T. 2022 [42]	**Examination of the moderating effect of mandatory CSR reporting on financial performance of listed firms in India**	**Indian stock market companies for 800 firm-year observations from 2010 to 2019**	**Hierarchical regression and panel regression with fixed effect assumptions**	**Positive relation between financial performance (ROA and Tobin's Q) and CSR expenditure**
Thomas, C.J., et al., 2021 [20]	**Empirical analysis of sustainability practices on firm performance using ESG data**	**Malaysia stock market companies for 36 public listed firms reporting ESG scores from 2015 to 2019**	**Static panel regression**	**Positive relation between ESG and financial performance, ROA, ROE, and Tobin's Q, but only significant for ROE**
Buallay, A. et.al., 2021 [43]	**Research on the relationship between the level of sustainability reporting and firm's performance**	**20 different smart city companies for 3536 observations from 2008 to 2017**	**Multiple regression model**	**Positive significant association between ESG and ROA, ROE; negative significant association between ESG and Tobin's Q**
Pham, D. C. et al. (2021) [44]	**Sustainability practices on the financial performance**	**Swedish companies for 116 listed firms in the year 2019**	**Multivariate regression model**	**Positive relationship between corporate sustainability and performance**
Buallay, A., et al., 2021 [45]	**Research on the relationship between ESG and a bank's performance (Tobin's Q)**	**Stock exchanges of MENA countries for 59 listed banks from 2008 to 2017**	**Fixed-effect regression model and IV-GMM (generalized model of moments)**	**Positive impact of ESG on performance; social performance plays a negative role in determining a bank's profitability and value**
Buallay, A. 2019 [46]	**Research on sustainability reporting's effect on performance with a comparison between manufacturing and banking sectors**	**Companies in 80 countries (932 manufacturers and 530 banks) for 11,705 observations from 2008 to 2017**	**Pooled data regression Model**	**Positive impact of ESG on performance in the manufacturing sector, besides negative effects in the banking sector**

As shown in **Table 1**, recent studies use different measures on different markets. Although these studies have found mainly positive relationships between SR and firm performance indicators, previous studies have found insignificant and negative relationships and their focus is on developed markets. These recent studies suggest that managers should allocate a proportion of their resources towards reporting on their attempts to mitigate the harmful impacts of their business operations, especially those in high-impact industries whose operations could be remarkably destructive.

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