Environmental, Social, and Governance Reporting

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This study examines the relationship between financial distress and environmental, social, and governance (ESG) disclosure. We hypothesize that financially distressed firms are tempted to enhance ESG disclosure as it provides higher performance in terms of financial and market perspectives. ESG disclosure needs substantial resources, which financially distressed firms may not be able to provide. In Indonesian settings, we find that financially distressed firms have lower ESG disclosure quality than non-distressed firms. Our results are robust due to lagged variable, Heckman's two stages, and coarsened exact matching regression showing consistent results. Furthermore, our results are consistent with three years of rolling windows of financial distress and all sections of ESG reporting, except the general information section. This study extends the scope of prior studies by focusing on firms' eagerness to provide higher quality ESG disclosure, particularly distressed firms.

Keywords: financial distress ; ESG disclosure ; CSR disclosure ; sustainability reporting ; risk preference

1. Introduction

Mounting studies examine the impact of ESG (environmental, social, and governance) reporting on firms, specifically on firm performance [1][2][3][4][5][6]. One of recent study examined 2200 unique primary studies that examined the relationship between ESG reporting quality and various proxies of firm performance such as operational-based performance (ROA, ROE, ROS) and market-based performance (shares market value, firms' capitalization, and Tobin's Q) [7]. In all these studies, ESG reporting is depicted from notable actions of firms because the majority of the publications found a positive relationship. Furthermore, we also found more than 2100 other empiric studies—particularly company-focused empiric studies—which suggest a positive ESG relationship [7].

Some studies find a negative relationship between ESG reporting and firm performance [8][9][10]. Primarily, their argument is based on the fact that ESG-oriented firms that need to show their ESG commitment commonly sacrifice their financial resources, and at the same time are not desired by all the stakeholders [11]. These findings show that the benefits of ESG reporting (or investments) may not be felt in all circumstances [12]. There may be conditions whereby firms do not experience the benefits of ESG reporting. The management of several firms may question this inconsistency of results. Thus, questions such as whether ESG reporting works out in firms' current conditions or whether ESG reporting is a solution for firms, are commonly raised by management.

Unlike most prior studies that focus on the impact of ESG reporting [13], we focuses on different perspectives, for instance, whether a firm desires to provide qualified ESG reporting. Some studies begin to question the ESG issue's worthiness [14][15], that it may be extended by focusing on the firm's perspectives. Surely, there is a crystal clear research gap where there are limited studies that document how firms react toward ESG reporting benefits. In typical cases, management would be intrigued by the benefits of ESG reporting offered. They would be competing to provide the highest quality ESG reporting to attain its maximum benefits. ESG reporting is closely related to image, brand, and the reputation of a firm [16], and those sustainability values are more cherished than others values by millennials [17][18]. Ideally, these advantages should be more stimulating for firms that desperately want to enhance their financial performance. For instance, financially distressed firms that are prone to ceasing their operations and bankruptcy will look to restore their financial conditions more than non-financial distressed firms. These rationales are consistent with impression management theory which utilizes discretionary disclosure as much as possible to achieve the firm's objective [19][20].

On the other hand, financially distressed firms may not provide high quality ESG reporting. This behavior is not because they do not want to, rather, they do not have sufficient capital in the form of finance and expertise. It is common for financially distressed firms to have limited access to strategies, thus forcing them to implement a low-cost strategy. Based on conservation of resources (COR) theory, management of financially distressed firms are irrational, and their fear of losing resources dampens their urge to attain higher performance [21][22]. This psychological trait deters firms from providing a high quality of ESG reporting. Based on these arguments, we posit that the level of desire to provide qualified ESG reporting differs between financially distressed to non-financial distressed firms.

2. Functions of ESG Reporting

2.1. ESG Reporting as Solution for Financial Distressed Firms

Financially, distressed firms will implement various strategies to recover from their financial conditions. Their "solutions" that have been documented by prior studies include capital restructuring [23][24], replacing cash dividend with share repurchases [25][26], increase monitoring function and decreasing CEO compensation [27]. Some firms prefer to swap cash-based compensation into equity-based compensation for management [28]. Such corporate actions are mainly conducted to increase the cash holding amount as it becomes urgent for financially distressed firms to hold substantial cash [29]. Other strategies that may be questioned from business ethic perspectives are also considered to cover the "true" financial conditions—for instance, earnings management [30] and tax avoidance [31].

Among all alternatives, managing corporate reporting is also considered a critical approach for financially distressed firms [32]. Corporate reporting is crucial for management to convey their operational results during a specific period [33]. One of the reporting types that has empirically proven to increase firm value is ESG reporting [34][35]. In addition, recent study finds that more than 2000 studies document a positive relationship between ESG reporting and firm performance [7]. Another study documents that firms with audited ESG reporting in Malaysia and Indonesia tend to have higher firm value than non-audited ESG reporting [36]. Another relevant study examines one of the sub-topics of ESG reporting, the carbon disclosure, and finds that higher quality of carbon disclosure leads to better firm performance [37]. These studies conclude that ESG reporting will assist the management in identifying and exploiting its competitive advantage, thus enhancing its performance.

Other ESG reporting studies examine the context of the financially distressed firm. For instance, [38] uses Indonesia as one of the countries where some of its giant state-owned enterprises are experiencing financial difficulties. They find that ESG reporting is one approach that effectively prevents financial distress in Indonesian listed firms. Another similar study examines the relationship between ESG reporting and financial distress possibility [39]. Using 651 publicly listed Australian firm-years' data covering the 2007–2013 period, they find ESG activities are negatively correlated with financial distress. In addition, they also find that the relationship is more pronounced in mature life cycle stages. Another recent study focuses on how ESG reporting helps financially distressed firms experience accelerated recovery from distress and are less likely to file for bankruptcy [13]. Their study became empirical evidence of ESG reporting benefits, especially in the context of financially distressed firms.

The positive relationship between financially distressed firms and ESG reporting is also in line with impression management theory. As a part of society, financially distressed firms come into the limelight for their stakeholders. Aware of this situation, management is motivated to maximize returns and minimize expected punishments, ensure their public image is consistent with their social role, and countering their damaged image due to their financial condition [20]. These motivations drove financially distressed firms' management to conduct a series of impression management strategies, of which one is discretionary disclosure [19], including ESG reporting. Although it may not be appropriate as ESG reporting is used as a "window dressing" method [40], impression management leads financially distressed firms to provide qualified ESG reporting.

2.2. ESG Reporting as Predicament for Financial Distressed Firms

Although [7] may end the debate of ESG reporting's benefits justifying that ESG reporting is a "solution" for every business condition and needs may be an overclaim. Looking closer at study [39], the benefits of ESG reporting on minimizing financial distress risk only apply in the matured firm and are not documented in the firm's early stages. Referring back to ESG reporting as a part of sustainable strategic management, it requires management to shift their paradigm from neoclassical economic to open-system assumptions underlying ecological economics [41][42]. This mindset change, without doubt, requires a substantial investment in terms of cost and expertise for its full implementation. These additional costs and expertise may not be covered by certain firms, particularly for financially distressed firms. Thus, in financially distressed firms' context, it is not merely that management does not experience ESG reporting benefit, rather they did not have that alternative to implement. Moreover, there is study that argues that the low financial distress risk of ESG-oriented firms may not be derived from its ESG reporting, instead it is coming from an extensive amount of resources that they control [37].

The refusal of ESG reporting in financially distressed firms also can be defined from COR theory. This psychology-originated theory states that human beings' primary motivation is to build, protect, and foster their resource pools to protect the self and the social bonds that support the self [43]. Its first principle points out that resource loss is disproportionately more salient than resource gain [22], which can justifies that not all firms are interested in maximizing the ESG reporting as it will sacrifice their resources. Notably, if the resources used to employ ESG reporting are in single or in a few momentums and insubstantial amount, the refusal of firms will be increased based on this theory, despite its promising benefits in the future.

In addition, COR theory highlights that the belief imbalance between resources loss and resources gain is more pronounced if the individual already lacks resources [43]. Financially distressed firms reflect that condition as they mostly have limited access to resources. Furthermore, both management and stakeholders are believed to enter a defensive mode to preserve the firm's resources, often defensive, aggressive, and irrational [22]. Combined with shareholders theory, which assumes that management will put their best effort to satisfy the shareholders' wants, it would be less likely for a financially distressed firm to provide a qualified ESG reporting.

The last argument for ESG lies in the shareholders' expense view. Based on this perspective, ESG helps other stakeholders at the expense of shareholders while ESG activities will harm the shareholders' wealth [9]. One of the economic experts states that "the only social responsibility of corporations is to make money" [44] and argues that ESG is just another representation of agency conflict [45]. These rationales are then supported by some studies finding that ESG activities (including ESG reporting) have a detrimental effects on corporations [8][9][10][11][46]. Indirectly, it will diminish the financial distressed firms' desire to provide qualified ESG reporting. This is also supported by critiques on ESG reporting [47], which highlight that the International Integrated Reporting Council's effort on encouraging ESG disclosure failed due to the reason that the additional reporting alongside the main financial statement could create confusion and could have very little impact on the financial reporting of companies. In this regard, some researchers suggest that current practices should consider a mutual recording of both financial and environmental aspects using two charts of accounts and multiple records [48]. Nevertheless, ESG also placed an additional burden on the firms in need to gather information on the impacts of a firm's activities on society and environment [47]. In cases when the impact of ESG reporting does not rebound on the firms, it would instead lead to a negative effect on future profitability [47].

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