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Review Article

A Literature Review on Environmental, Social and Governance Reporting and It's Impact on Financial Performance

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Abstract

The purpose of this paper is to examine the needs of Environmental, Social, Governance (ESG) reporting and its impact on financial performance of listed companies. It shows that there are both positive and negative relationships between ESG reporting and financial performance of a company. Further researches are therefore suggested in this paper to determine the content and mode of ESG regulations, improve theorizing and assessing the relationship between the EGS and financial performance of a company and study the longer-term analyst forecasts to assess the impact of ESG reporting and its impact on financial performance of a company.

Keywords: Environmental, social and governance (ESG) reporting; Corporate social responsibility (CSR); Financial performance; Environmental disclosure

Introduction

Over the past decade, a growing number of securities regulators and stock exchanges worldwide have acknowledged that information on companies' nonfinancial or "Environmental, Social and Governance (ESG)" performance which the potential risk indicated by the ESG information may be material to investors and to the stability of modern capital markets [1]. There are over 60 jurisdictions, including members of G20, require or encourage corporations to disclose ESG information along with their financial reports (ibid).

Environmental, Social and Governance (ESG) is a term that is commonly employed in Corporate Social Responsibility (CSR) [2-4] and ESG information is becoming everybody's concern because of the possible long-term impact given to the investment community and also to other stakeholders at large [2].

Since most firms are unwilling to voluntary reveal information to outsiders, objective information about ESG about the organization is not easy to obtain. The purpose of this paper is to present a literature review regarding how to assess the quality of ESG information and the effect ESG reporting has on companies' financial performance.

The Needs for ESG Reporting

Investors are become more demanding for ESG information. It is because timely, reliable, consistent, and comparable ESG information is relevant to their investment decisions. This expectation from investors makes corporations invest more resources on producing ESG reports in order to satisfy the need of investors.

The first environmental reports were published at the end of the 1980s and quickly became widespread among multinational companies which the reasons for sustainability reporting are because of the environmental challenge, social challenge and economic challenge [5]. Lamberton [6] states the primary objective of the sustainability accounting framework is to measure organizational performance toward the objective of sustainability.

ESG reporting is referred to by a number of different names including, but not restricted to Corporate Social Disclosure (CSD), Corporate Environmental Reporting (CER), Triple Bottom Line (TBL) reporting, Corporate Social Responsibility Disclosure (CSRD) and Corporate Sustainability (CS) reporting [2]. The practice of measuring, disclosing and being accountable to internal and external stakeholders for companies' performance in ESG reporting towards the goal of sustainable development. ESG information is prominent for investors to perform financial analysis and make investment decisions. ESG reporting includes the measures of company's emissions, use of resources, the environment and natural resources, labour and human rights policies, health and safety, supply chain management, product responsibility, anti-corruption, and community investment etc. Investors increasingly see the importance of ESG report as it relates to company's operational strength, efficiency and its risk management. Therefore, ESG reports can provide relevant additional information to support the traditional financial and investment analysis and affect the long-term value of a company's security. It provides balanced and reasonable representation of sustainability performance for both positive and negative contribution of the company and not just its sustainability targets and objectives.

ESG reporting is a measure to achieve transparency about the respective performance of a firm and a means of communication to stakeholders including shareholders and investors, employees, clients and the committees which such reports are useful tools for both the reporting firm and stakeholders and are clearly an indicator of the importance of ESG issues in a firm [7]. The issue for drafting the ESG report is to determine the scope of the report, i.e. to determine which part of the business has to report on. This could include geographical scope (e.g. operations in selected area(s) but not all geographical

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locations that a company operates) or by business (e.g. only the selected aspect(s) of the business but not the others).

For example, in 2015, the Hong Kong Stock Exchange published consultation conclusions to upgrade some of the provisions in the ESG Reporting Guide (the "Guide") (Appendix 27 of the Main Board Rules and Appendix 20 of the GEM Rules) to "comply or explain". Starting from 1 January 2016, the amended ESG Guide was applied to 2,027 (as of May 2017) listed companies on both the main and Growth Enterprise Market (GEM) boards of the stock exchange and they must disclose ESG information on an annual basis and regarding the same period covered in their annual report. In fact, major exchanges around the world strengthening their requirements for listed companies to disclose their environmental, social and governance obligations [8] and hence ESG report is now a statutory requirement for listed companies in Hong Kong.

Literature Review

Sustainable development was first defined by World Commission on Environment and Development as development that meets "the needs of the present without compromising the ability of future generations to meet their own need" in 1987 and enterprises should understand how corporate sustainability is constructed in a specific context and how the concept of sustainable development can be applied to the business level and what enterprises should do when they want to became sustainable [9].

Corporate social reporting has been the subject of substantial academic accounting research for several decades [10], its implications have also been proved with positively correlated with the financial performance.

The current practice to report sustainability performance for most organisations are to publish a sustainability report, either in conjunction with, or separately from, the company's annual report but the sustainability reports are not often integrated with conventional economic reports, tend to focus on the positive information, and focus on descriptive outcomes [11].

The pressure for corporate accountability is increasing [12,13]. More companies are voluntarily to produce ESG report in addition to its financial reports in order to provide more relevant information to assess its financial and non-financial performance [14].

Recently, there is an increasing demand for integrated reporting which companies are required to publish a report to contain both sustainability and financial statements in order to reduce agency costs, political costs and information asymmetries and integrated reporting provides a broader explanation of performance [15].

The Social and Environmental Accounting (SEA) literature provides a range of views and arguments on and around the importance of corporations adhering to ESG expectations of the communities within which they operate but seldom of these consider the motivations behind corporate environmental reporting, deterrence and avoidance of civil regulatory action is proposed as an alternate motivation for such reporting, and an area for future research [16].

ESG reporting influences both financial and environmental performance of a company. Weber [7] analyses the ESG reporting of China Top 100 Green Companies and concludes that good ESG reporting contributes better financial returns and improvement of corporate environmental performance. Chen, Feldmann, & Tang [17] indicate that the categories of Human Rights, Society as well as Product responsibility display a significant and positive correlation with the return on equity.

One of the key issues is how to assess the quality of ESG reports. Currently there are many international institutions such as Global Reporting Initiative (GRI), United Nations Conference on Trade and Development (UNCTAD), The European Federation of Financial Analysts Societies (EFFAS) and regulatory bodies such as Hong Kong Stock Exchange (HKEx) develop the Key Performance Indicators (KPIs) for ESG reporting. Different organizations including United Nations, G20, OECD, European Union, and different countries such as Netherlands, France, Germany, United Kingdom, India, Japan, Philippines, and Vietnam etc. initiate the disclosure of ESG information in reporting. This creates the problems of lack of consensus, and companies may select indicators which only provide positive and favorable results. Therefore, it is important to establish a unique set of ESG key performance indicators to support investors' decisions. Such KPIs creating a reliable method of measuring the performance of ESG, where the effect of more complex factors can be considered a prerequisite for success not only in decisions, but also with regard to corporate management, possibility for comparison, competitiveness of companies, etc. by address ESG problems and corporate governance in relation to the measurement of business performance, as well as its continued success (sustainability success) [18]. Ondoro [19] suggests the use of Balanced ESG framework to measure the performance of an organization which industry practitioners may find this useful as this exposes external and internal as well as long term and short term perspectives of performance. Without an agreed measurement basis, it is difficult to assess the ESG performance of a company.

Although the body of empirical literature on the ESG and financial performance of a company link is vast, it remains inconclusive. There are studies reporting positive, negative as well as neutral relationships between ESG and financial performance of a company [20,21].

Many researchers find socially responsibility is to be positively related to an organizations' financial and social performance [22-26]. Russo and Fouts [27] have identified CSR as a source of competitive advantage which a firm can create a sustainable competitive advantage and therefore engaging in corporate social responsibility issues could be a worthwhile consideration for a firm's management [20].

Bernardi and Stark [28] find evidence of a strengthened relationship between ESG, environmental and governance disclosure levels and analyst forecast accuracy following the introduction of Integrated Reporting for both financial services firms and those from the other sectors.

Numerous positive benefits are asserted including better internal resource allocation decisions; external market benefits such as meeting the needs of mainstream investors who want Environmental, Social and Governance (ESG) information [29].

But some researchers find that there is a short-term negative impact on financial performance when firms applied the sustainability

strategies which are officially required [30].

Same as traditional financial reporting, ESG reports can only provide historical information to its users and hence the ESG information may not be relevant to investment decision. In some countries, the ESG reports are not statutory reports or corporations are only required to provide explanation of why it cannot comply with the statutory requirements (e.g. the codes of provisions). This makes the investors not able to assess the company's ESG issues.

Some researchers argue that socially responsible initiatives create additional costs that may have negative impact on companies' financial performance and hence become less competitive than those less socially responsible organizations [10,31,32]. Lamberton [6] criticizes that corporate impacts on the environment can be changed by the provision of relevant information to stakeholders such as businesses pass environmental taxes on to consumers to partially offset the under pricing of economic goods and services from the failure to include environmental and social costs in market prices.

Kalinowski [33] finds out that there is no clear correlation between sustainability support variables and stock market size variables. Adams & González [34] argue that further research engaging with organisations is needed in order to identify how accounting and management systems might reduce their negative sustainability impacts.

Although there has become available a greater quantity of ESG information, many companies display a lack of understanding about how to approach integrated reporting, often presenting reports with excessive repetition of information [29].

Ho [1] states ESG reporting remains inadequate for financial analysis, even as the quantity of publicly available ESG information has grown exponentially. She explains the deficiencies of public ESG information are a side-effect of the flexibility the current mix of voluntary and mandatory ESG reporting provides.

Based on different views on the relationship between the EGS and financial performance of a company, there is no conclusion regarding the impact of ESG information on a company's financial performance.

Conclusion

There is an increasing demand of ESG reporting from the public including the government officials such as Stock Exchange, investors, financial analysts, and other stakeholders as ESG information can provide additional information for its users to assess not only the ESG performance but also the financial performance of a company which their investment decisions are based. This literature review consolidated different arguments regarding the relation between ESG reporting and its impacts on a company's financial performance.

This literature review therefore suggests that further contributions might be made by future research on first, the content and mode of ESG regulations. Second, endeavors engaging with listed companies as there is potential to improve theorizing and assessing the relationship between the EGS and financial performance of a company. Finally, longer-term analyst forecasts could be studied to assess the impact of ESG reporting and its impact on financial performance of a company.

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