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THE IMPLICATIONS OF SUSTAINABILITY REPORTING

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THE IMPLICATIONS OF SUSTAINABILITY REPORTING

by

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ABSTRACT

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Firms prepare sustainability reports along with their financial statements to disclose their non-financial information, such as their environmental, social, and governance (ESG) activities. The practice of sustainability reporting is growing as stakeholders care more about ESG issues. Researchers have studied the financial performance and sustainability reports of non-U.S. firms to determine if engaging in sustainability reporting is related to firm financial performance. To further understand this relationship, numerous measures of financial performance were used along with a calculated sustainability disclosure score for 2,367 North American firms to run a correlation and regression. Three of the nine financial performance indicators produced relevant results in the correlation, two negative and one positive. The regression analysis provides similar findings; however, the coefficient of determination, R^2, was only 0.019. Unlike prior studies, this study finds only limited evidence of a relationship between the financial performance indicators and the sustainability disclosure score.

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CHAPTER 1

INTRODUCTION

In recent years, increased public awareness of environmental, social, and governance (ESG) issues has prompted businesses to alter their business practices. Under public scrutiny, firms need to prove to stakeholders that they are operating sustainably. This need led to the rise of sustainability reporting. A sustainability report is published by a firm to report its non-financial ESG performance either separately or alongside its financial report. A sustainability report may also be referred to as a corporate social responsibility (CSR) report or a triple bottom line report. Sustainability reporting by a firm shows transparency, which is appreciated by stakeholders. This paper aims to show that sustainability reporting of ESG actions is related to enhanced financial performance for firms publicly traded in North America. This information will help firms decide whether implementing more sustainable practices and engaging in sustainability reporting could improve their business.

There were several limitations and assumptions made for this study. This study only includes 2,367 companies that are publicly traded in North America, for which I was able to obtain MSCI sustainability data and Compustat financial statement data. For the study, the selected companies are assumed to be an accurate representation of all companies. Not all aspects of financial performance were selected to be analyzed. This study does not look at the industries of the analyzed firms. Industry- or company-wide

issues that may have caused abnormal financial performance during the year analyzed are not considered in the model.

CHAPTER 2

LITERATURE REVIEW

2.1 Sustainability Reporting Overview

Sustainability reporting is a growing phenomenon worldwide. Gabrusewicz (2013) examined how sustainability is defined today, and how that definition has evolved over time. He explains how sustainability no longer refers only to the environment but has grown to encompass other areas such as financial, economic, and social issues. He maintains that businesses now use the term "sustainability" interchangeably with corporate social responsibility. To give stakeholders a more complete view of the organization's environmental, social, and governmental (ESG) efforts and investments, the normal accounting standards are expanded for the practice of sustainability reporting according to Gabrusewicz. He believes that firms can obtain a competitive advantage by engaging in sustainability accounting. Sustainable practices were found to create synergy and to help businesses adapt to an evolving environment.

People's view of sustainability reporting is evolving. Businesses and their stakeholders are beginning to view this type of reporting as beneficial, if not necessary. Schaltegger and Burritt (2010) analyzed how different types of accounting such as financial accounting, cost accounting, and now sustainability reporting have developed over time. They also questioned the reasons behind the movement toward sustainability accounting for businesses and found answers such as a desire to greenwash, pressures from the industry, legislative bodies, and stakeholders and ethical or corporate responsibility reasons

In addition, they found that another reason managers engaged in sustainability accounting is that they see the potential for cost reduction and revenue increases through ESG efforts. They found that tools to better account for sustainability efforts need to be further developed to be beneficial for businesses and their stakeholders.

Schooley and English (2015) observed that U.S. companies are falling behind in the global rise in sustainability reporting and they need to standardize their reporting. Most of their research addressed the advantages of the Sustainability Accounting Standards Board's (SASB) standards. The article also considered the possibility that a corporation's perceived dedication to ESG matters could lead to changes in market shares as investors choose to invest in sustainable companies over less sustainable competition.

Perrini and Tencati (2006) studied why sustainability accounting systems are needed and how best to address this need. They found that firms need to address all stakeholders, not solely stockholders, when creating strategy, and that this includes addressing ESG issues. Perrini and Tencati (2006) developed a system sustainability evaluation and reporting system (SERS) that they think will solve the need to address all stakeholders by incorporating sustainability efforts and results. They found that expanding on traditional accounting frameworks to integrate sustainability issues could benefit companies through improved stakeholder relations and wealth creation.

Fernandez-Feijoo, Romero, and Ruiz (2014) analyzed the effect that stakeholders had on transparency in sustainability reporting. They found that pressures from stakeholders did lead to more transparency. For their study, they considered customers, employees, investors, and the environment. They observed that transparency is higher overall for firms that have adopted long-term sustainability policies than those with no such

policy. Their research found that investors, employees, and consumers have greater impacts on sustainability reporting transparency than the environmental-sensitivity of the industry. This finding highlighted the significance of external pressures on sustainability reporting.

2.2 Sustainability Reporting and Financial Performance

Researchers have noted the public's desire for sustainability reporting, and many have directed their attention to this growing trend. Several studies have tried to identify a relationship between sustainability reporting and financial performance. Ameer and Othman (2012) performed a study looking at the 100 most sustainable global companies of 2008. The two researchers analyzed the companies' sustainability practices, returns on assets, profits before taxes, and cash flows from operations, and compared each to control companies in the same industries. They found that "companies which place emphasis on sustainability practices have higher financial performance… compared to those without such commitments in some activity sectors" (Ameer and Othman 2012, p.73).

Berthelot, Coulmont, and Serret (2012) aimed to determine whether investors place a higher value on the stock of companies that publish sustainability reports. For their study, they used Canadian companies that are listed on the Toronto Stock Exchange and looked at their market capitalization, book value of common equity, net earnings, and frequency of sustainability reports. The results of their study suggest the firms that invested in sustainability reporting were wise to do so since it resulted in a stock price premium in financial markets.

Jones, Frost, Loftus, and Van Der Laan (2007) conducted a study to determine whether sustainability reporting was related to financial and market performances for

Australian firms. They chose to analyze the top 100 companies on the Australian Securities Exchange for their research. To conduct their analysis, they used the latest annual report and sustainability report as of early 2004, as well as the company website for each firm. They created their own sustainability disclosure score to make the firms' sustainability disclosures more useful for their analysis. Jones et al.'s (2007) results indicated that firms with overall higher sustainability disclosure scores tended to have better financial performance in areas such as operating cashflows, cash position, working capital, price to book value, and retained earnings. However, they found a negative relationship between sustainability disclosure scores and abnormal returns.

Moneva, Rivera-Lirio, and Munoz-Torres (2007) performed a study to see if a relationship existed between a company's commitment to its stakeholders and its social and financial performance. The researchers used the main listed firms on the Spanish stock market for their study. They analyzed the effect of the transparency of firms in reporting their ESG effects on shareholders. Based on the results of their study, they concluded that the application of corporate social responsibility (CSR) strategies is positively associated with firms' financial performance. For their study, CSR strategies meant that corporate principles were applied internally and that the firm provided sustainability information externally.

Reddy and Gordon (2010) researched how sustainability reporting affects firms' financial performance by analyzing the sustainability reports and abnormal returns of firms on the New Zealand Stock Exchange (NZX) and 51 listed in the Australian Stock exchange (ASX). They defined a sustainability report as a report that the firm provides on a voluntary basis that discloses additional information on the environmental and societal impact of the

firm's activities. The researchers found that abnormal returns were positively related to sustainability reporting for Australian firms. For New Zealand firms, they found a positive relationship that was not statistically significant between sustainability reporting and market returns.

Burhan and Rahmanti (2012) analyzed 32 non-financial companies on the Indonesian Stock Exchange (IDX) from 2006-2009 to determine the relationship between sustainability reporting in its entirety, and each element of sustainability reporting, with the financial performance of the firms. For their study, they defined sustainability reporting as a non-financial report disclosing the economic performance, environmental performance, and social performance of the firm. Burhan and Rahmanti's results were inconclusive. They found both positive and negative results through their study.

The research that has been conducted in this field of study indicates that sustainability reporting is an important issue for stakeholders and businesses. Sustainability reporting will affect the firms' strategies, perceptions to the public, and possibly performance. This research study differs from research done in the past because it examines the association between sustainability reporting and financial performance for North American firms.

CHAPTER 3

METHODOLOGY

This study aims to apply the research methodology of Jones et al. (2007) to publicly traded firms in Canada and the U.S. Instead of scoring the sustainability disclosures myself, which is the approach used by Jones et al. (2007), I relied on information from the MSCI database to assess firms' sustainability reporting. I collected the financial performance data for the companies from the Compustat database. The final sample consists of 2,367 companies that had necessary data from both MSCI and Compustat for the year 2014.

MSCI utilizes a binary scoring model to score the ESG performance of the companies studied. The ESG performance is determined by disclosures reported by the firms. MSCI assigns a "1" to a company that met the criteria established for an indicator and a "0" to a company that did not meet the criteria. If the company was not researched for a particular ESG indicator, the database notes "NR" for not researched. MSCI tracks both positive indicators and negative indicators of sustainability performance and recommends that researchers calculate a firm's sustainability performance score as the sum of all positive factors scored as "1" less the sum of all negative factors scored as "1." Since I am interested in firms' overall sustainability disclosures in this study, regardless of whether the disclosures related to positive or negative signals of sustainability performance, I sum all indicators scored as "1" and use this total as the sustainability disclosure score.

Table 3.1 shows the sustainability indicators used for this study. The table shows the minimum and maximum possible score, the average, and the standard deviation for each indicator. The table also includes the minimum, maximum, average, and standard deviation of the sustainability disclosure scores calculated for the 2,367 firms.

Table 3.1: Descriptive Statistics for Sustainability Indicators

Sustainability Indicators	Min.	Max.	Mean	Std. Deviation
Environmental Opportunities - Clean Tech	0	1	0.133	0.340
Waste Management - Toxic Emissions and Waste	0	1	0.075	0.263
Waste Management - Packaging Materials & Waste	0	1	0.222	0.420
Climate Change - Carbon Emissions	0	1	0.184	0.388
Environmental Management Systems	0	1	0.396	0.489
Natural Resource Use - Water Stress	0	1	0.088	0.284
Natural Resource Use - Biodiversity & Land Use	0	1	0.083	0.276
Natural Resource Use - Raw Material Sourcing	0	1	0.210	0.408
Natural Resource Use - Financing Environmental	0	1	0.090	0.288
Environmental Opportunities - Green Buildings	0	1	0.315	0.466
Environmental Opportunities in Renewable Energy	0	1	0.239	0.430
Waste Management - Electronic Waste	0	1	0.067	0.252
Climate Change - Energy Efficiency	0	1	0.132	0.339
Climate Change - Product Carbon Footprint	0	1	0.150	0.358
Climate Change - Insuring Climate Change Risk	0	1	0.308	0.464
Regulatory Compliance	0	1	0.063	0.242
Toxic Emissions and Waste	0	1	0.076	0.266
Energy & Climate Change	0	1	0.016	0.124
Impact of Products and Services	0	1	0.008	0.089
Biodiversity & Land Use	0	1	0.008	0.092
Operational Waste	0	1	0.000	0.021
Supply Chain Management	0	1	0.005	0.074
Water Stress	0	1	0.000	0.021
Environment - Other Concerns	0	1	0.000	0.000
Community Engagement	0	1	0.201	0.402
Indigenous Peoples Relations	0	1	0.380	0.486
Union Relations	0	1	0.077	0.266
Cash Profit Sharing	0	1	0.025	0.266
Involvement	0	1	0.127	0.333
Employee Health & Safety	0	1	0.096	0.295

Supply Chain Labor Standards	0	1	0.201	0.402
Human Capital Development	0	1	0.112	0.316
Controversial Sourcing	0	1	0.154	0.362
Human Capital - Other Strengths	0	1	0.102	0.302
Social Opportunities - Access to Healthcare	0	1	0.080	0.273
Product Safety and Quality	0	1	0.206	0.405
Access to Finance	0	1	0.058	0.235
Social Opportunities - Access to Communications	0	1	0.286	0.457
Social Opportunities - Opportunities in Nutrition and Health	0	1	0.142	0.350
Product Safety - Chemical Safety	0	1	0.076	0.265
Product Safety - Financial Product Safety	0	1	0.244	0.432
Product Safety - Privacy and Data Security	0	1	0.234	0.424
Product Safety - Responsible Investment	0	1	0.095	0.294
Product Safety - Insuring Health and Demographic Risk	0	1	0.054	0.227
Community Impact	0	1	0.032	0.176
Support for Controversial Regimes	0	1	0.001	0.036
Freedom of Expression and Censorship	0	1	0.003	0.054
Human Rights Violations	0	1	0.008	0.089
Human Rights - Other Concerns	0	1	0.014	0.117
Union Relations Concern	0	1	0.016	0.127
Health and Safety Concern	0	1	0.027	0.162
Supply Chain Controversies	0	1	0.010	0.100
Supply Chain -Child Labor	0	1	0.005	0.074
Labor Rights & Supply Chain - Other Concerns	0	1	0.000	0.000
Workforce Diversity	0	1	0.010	0.098
Product Quality & Safety	0	1	0.065	0.246
Marketing & Advertising	0	1	0.014	0.119
Anticompetitive Practices	0	1	0.029	0.167
Customer Relations	0	1	0.024	0.152
Other Concerns	0	1	0.002	0.041
Corruption & Instability	0	1	0.182	0.386
Financial System Risk	0	1	0.456	0.500
Governance Structures Controversies	0	1	0.005	0.071
Controversial Investments	0	1	0.000	0.021
Bribery & Fraud	0	1	0.057	0.232
Governance - Other Concerns	0	1	0.000	0.000
Sustainability Disclosure Score	0	21	1.770	2.635

I collected all financial statement data from Compustat, including: total assets (AT), book value per share (BKVLPS), capital expenditures (CAPX), cash (CH), common shares outstanding (CSHO), earnings before interest and taxes (EBIT), total intangible assets (INTAN), total liabilities (LT), operating activities net cash flow (OANCF), price close – annual – fiscal (PRCC_F), retained earnings (RE), total stockholders' equity (SEQ), total interest and related expense (XINT), and balance sheet working capital (WCAP). I then used the Compustat data to calculated the following financial ratios analyzed by Jones et al. (2007):

Cash position to total assets = CH/AT

Net operating cash flow to total assets = OANCF/AT

Total liabilities to total equity = LT/SEQ

Working capital to total assets = WCAP/AT

Retained earnings to total assets = RE/AT

Price to book value = PRCC_FF/BKVLPS

Net tangible asset per share = (AT – INTAN – LT) / CSHO

Capital expenditure to total assets = CAPX/AT

Interest cover ratio = EBIT/XINT

Table 3.2 shows the number of observations, minimum, maximum, average, and standard deviation for each of these financial indicators.

Table 3.2: Descriptive Statistics for Financial Indicators

Financial Indicators	N	Minimum	Maximum	Mean	Std. Deviation
Cash position to total assets	2367	0.017	0.144	0.081	0.090
Net operating cashflow to total assets	2367	0.020	0.127	0.074	0.075
Total liabilities to total equity	2367	-416.125	2561.872	1072.873	2105.762
Working capital to total assets	2367	0.072	0.220	0.146	0.104
Retained earnings to total assets	2367	-0.057	-0.003	-0.030	0.038
Price to book value	2367	-1106.986	277.948	-414.519	979.296
Net tangible asset per share	2367	-81.653	-6.399	-44.026	53.213
Capital expenditure to total assets	2367	0.015	0.026	0.020	0.008
Interest cover ratio	2367	-0.462	8.018	3.778	5.997

The means for liability to total equity, price to book value, and net tangible asset per share are much different from the means calculated in the study by Jones et al. (2007). This could be attributed to outliers in the sample or differences between Australian and North American firms. An additional regression was run that removed the outliers for these financial performance indicators. The regression results were essentially unchanged when the outliers were removed.

Following the methodology of Jones et al. (2007), I examine the association between sustainability reporting and firm financial performance with the following regression model:

$$\begin{aligned} &\textit{Sustainability Disclosure Score}_i = \alpha_0 + \alpha_1\, \textit{Cash position to total assets}_i \\ &+ \alpha_2\, \textit{Net operating cashflow to total assets}_i + \alpha_3\, \textit{Total liabilities to total assets}_i \\ &+ \alpha_4\, \textit{Working capital to total assets}_i + \alpha_5\, \textit{Retained earnings to total assets}_i \\ &+ \alpha_6\, \textit{Price to book value}_i + \alpha_7\, \textit{Net tangible assets per share}_i \\ &+ \alpha_8\, \textit{Capital expenditure to total assets}_i + \alpha_9\, \textit{Interest cover ratio}_i + \varepsilon \end{aligned}$$

CHAPTER 4

DISCUSSION

I first examine the association between sustainability reporting and financial performance with a correlation analysis. Table 4.1 conveys correlation results. The correlation table shows that a negative relationship exists between the sustainability disclosure score and cash position to total assets, total liabilities to total equity, working capital to total assets, and interest cover ratio. This finding suggests that sustainability reporting increases as these financial performance measures decrease. A positive relationship exists between the sustainability disclosure score and net operating cashflow to total assets, retained earnings to total assets, price to book value, net tangible asset per share, and capital expenditure to total assets. This finding suggests that the sustainability score increases as these financial performance measures also increase.

Total liabilities to total equity, retained earnings to total assets, price to book value, net tangible asset per share, capital expenditure to total assets, and interest cover ratio all have very low correlations, between -0.03 and 0.03, suggesting that there is almost no relationship between these financial performance indicators and the sustainability score. Working capital to total assets has a negative relationship with a correlation of nearly -0.130, and cash position to total assets has a negative relationship with a correlation of nearly -0.089. These both have relatively stronger correlations and these financial performance indicators tend to fall when sustainability performance increases. This finding could mean that the cost of sustainability reporting causes these financial performance

indicators to drop. Another interpretation is that firms with higher working capital to total assets or cash position to total assets are less motivated to report on their sustainability. Net operating cashflow to total assets has a positive relationship with a correlation of approximately 0.047. This result could mean that firms with higher net operating cashflow are more likely to engage in sustainability reporting. Another interpretation is that firms that provide sustainability reports tend to have higher net operating cashflow.

Table 4.1: Sustainability Disclosure Score and Financial Indicators Correlation

Financial Indicators	Correlation to Sustainability Disclosure Score
Cash position to total assets	-0.089
Net operating cashflow to total assets	0.047
Total liabilities to total equity	-0.002
Working capital to total assets	-0.130
Retained earnings to total assets	0.029
Price to book value	0.002
Net tangible assets per share	0.014
Capital expenditure to total assets	0.014
Interest cover ratio	0.000

The results of the ordinary least squares (OLS) regression are displayed in Table 4.2. The adjusted R^2 was calculated to be approximately 0.019. This means that only 1.9% of the variation in the sustainability disclosure score could be attributed to variation in the financial performance measures. For this study, a p-value of less than 0.10 indicates that the financial performance indicator and sustainability disclosure score have a relevant relationship. Two financial performance indicators generated p-values of less than 0.10: net operating cashflow to total assets and working capital to total assets. This finding is different from that of Jones et al. Jones et al. calculated p-values of less than 0.10 for all of their financial variables. Working capital to total assets has a coefficient of approximately -1.839. This finding is different from that of Jones et al. as well. Jones et al. found a

coefficient of 0.137. The other financial performance indicators did not generate significant p-values in the regression. The results of the regression provided only weak evidence of an association between sustainability reporting and the financial performance of North American firms.

Table 4.2: Sustainability Disclosure Score and Financial Indicators Regression

	Coefficients	t Stat
Intercept	2.034	22.756
Cash position to total assets	0.076	0.148
Net operating cashflow to total assets**	0.832	2.034
Total liabilities to total equity	0.000	-0.383
Working capital to total assets***	-1.839	-5.481
Retained earnings to total assets	0.001	0.022
Price to book value	0.000	0.265
Net tangible assets per share	0.000	0.789
Capital expenditure to total assets	-0.614	-0.804
Interest cover ratio	0.000	-0.335
Adjusted R Square	0.019	
Observations	2367	

P-value of <1% ***

P-value of 1-5% **

P-value of 5-10% *

P-value of >10% no *

CHAPTER 5

CONCLUSION

Sustainability is a growing trend, and a growing number of firms are exploring ways to engage in sustainability reporting. Several studies have detected a relationship between sustainability reporting and the financial performance of non-U.S. firms. This study finds limited evidence of an association between sustainability disclosures to stakeholders and financial performance for North American firms. Specifically, the regression results suggest that sustainability reporting is negatively associated with working capital to total assets and positively associated with net operating cashflow to total assets. The negative relationship between cash position to total assets and the sustainability disclosure score conveys that the more efficient the cash flow of a firm, the lower the level of sustainability disclosure. The negative relationship between working capital to total assets and the sustainability disclosure score shows that the higher the amounts of assets needed for day-to-day operations, the lower the sustainability disclosure score. The positive relationship between net operating cashflow to total assets and the sustainability disclosure score indicates that the higher the amount of money made per dollar of assets, the higher the level of sustainability disclosure. The lack of significance for the other financial measures and the small adjusted R^2 for the regression model reveal that the financial performance indicators explain the level of sustainability disclosures of firms poorly in this study.

In further studies, the positive and negative indicators used to calculate the sustainability score could be further broken down and analyzed based on whether an economic, social, or governmental indicator has more effect on the financial performance. A Tobit regression could be implemented instead of the OLS regression. The companies could also be grouped and analyzed by their industry to see if financial performance measures have a stronger effect on sustainability reporting in some industries. A much larger study could be conducted that considers other issues affecting the industry or company in the studied period and how these issues interact with sustainability reporting and financial performance.

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BIOGRAPHICAL INFORMATION

Hope Clark began at the University of Texas at Arlington in Fall 2014 and will graduate in May 2017 with her Honors B.B.A. in Accounting. While attending school, Hope was a member of the Accounting Society and the Honors College, and she completed an internship at Agricultural Workers Mutual Auto Insurance Company. After graduation, Hope plans to return for graduate school and earn her M.S. in Accounting, and eventually become a Certified Public Accountant.