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The Influence of Sustainability Reporting in Enhancing Firm Value

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Abstract: There is a growing concern about sustainability reporting as stakeholders increasingly recognize the importance of sustainable and ethical business practices. Investors, consumers, and regulatory bodies are demanding greater transparency and accountability from firms regarding their sustainability and ethical corporate behavior. Accordingly, the objective of this paper is to examine the significant influence that sustainability reporting can exert on a firm's financial performance and overall worth. By employing three predominant theoretical frameworks: stakeholder theory, legitimacy theory, and signaling theory. The findings mostly show that sustainability reporting increases firm value. Reputational capital, investor confidence, and long-term financial performance improve for firms that report their sustainability performance. However, sustainability reporting affects business value through complicated mechanisms that include regulatory contexts, industry characteristics, and disclosure quality. Although positive associations were found, sustainability reporting's effects on firm value need further studies. Research should uncover the mediating variables and contextual elements that promote this association. Researchers can provide more detailed insights into how sustainability reporting might strategically boost firm value, improving corporate sustainability and financial performance. The findings of this study would provide an important contribution to firms and stakeholders. Firms that prioritize sustainability contribute to the well-being of communities and the environment. Further, with greater transparency, the public can hold companies accountable for their actions, and support firms that demonstrate genuine commitment to sustainability.

Keywords: *Firm value, Legitimacy theory, Signaling theory, Stakeholder theory, Sustainability Reporting*

1. Introduction

In today's rapidly evolving business landscape, sustainability has become an essential component for long-term success and competitive advantage (Buallay, 2020; Sołoducho-Pelc & Sulich, 2020). Companies are increasingly recognising the importance of incorporating environmental, social, and governance (ESG) factors into their strategic blueprint. Sustainability reporting, which involves disclosing a firm's ESG practices and impacts, has become a key tool for communicating these efforts to stakeholders (Mohammad & Wasiuzzaman, 2021).

The adoption of sustainability reporting provides numerous benefits, including bolstering corporate reputation, enhancing risk management, and increasing access to financing (Petrescu et al, 2020). Investors, consumers, and regulatory agencies are increasingly requesting enhanced transparency and accountability, compelling corporations to embrace more sustainable practices (Christensen et al., 2021).

A comprehensive survey conducted by KPMG in 2022 examined global sustainability reporting trends, encompassing 5,800 companies across 58 countries, territories, and jurisdictions. The survey reveals that regulators and non-profit standard-setters worldwide have recently intensified efforts around non-financial disclosure (KPMG, 2022). Notably, in April 2021, the European Commission adopted the Corporate Sustainability Reporting Directive (CSRD) proposal, mandating large companies to report on social and environmental impacts starting in 2024. According to KPMG's 2022 report, 96% of G250 companies now disclose information on sustainability or ESG matters.

This high level of disclosure demonstrates a strong commitment to transparency and accountability among the top global firms, potentially driving better sustainability practices. Furthermore, such widespread reporting can enhance investor confidence, attract sustainability-focused investments, and encourage other companies to adopt similar practices. This would in turn promote greater positive impacts on environmental and social issues globally.

Additionally, the Asia-Pacific region has experienced the most significant increase in sustainability reporting, with the proportion of companies participating rising from approximately 50 percent to nearly 90 percent (Statista, 2024). This remarkable growth highlights the region's commitment to transparency and sustainable business practices.

While sustainability disclosure is becoming more common, there are still uncertainties regarding its actual impact on firm value. Does comprehensive sustainability reporting genuinely enhance long-term financial performance, or are firms primarily engaging in these practices to meet regulatory requirements and satisfy stakeholders?

Sustainability reporting involves sharing non-financial information about a firm's ESG performance. This allows stakeholders to understand the firm's sustainability initiatives and how they align with global sustainability objectives (Abeysekera, 2022). This form of reporting extends beyond conventional financial statements to encompass information on a firm's environmental management, social initiatives, and adherence to governance norms (Stocker, et al., 2020). A corporation can showcase its dedication to sustainable development and ethical business practices by providing a thorough overview of its operations.

Sustainability reporting has become a focal point in recent years, as firms are increasingly acknowledging the significance of incorporating ESG concerns into their operational strategies (Uyar, 2016). The acknowledgment of sustainable business practices is influenced by a combination of legislative demands, stakeholder expectations, and the strategic advantages they offer. Investors, consumers, and regulatory agencies are increasingly requesting corporations to provide more openness and responsibility in disclosing their sustainability practices (Oncioiu, 2020). This expectation is grounded in the recognition that sustainability is not just a moral obligation but also a crucial element in guaranteeing the long-term profitability of a business.

The increasing focus on sustainability reporting arises from the accumulating evidence that sustainable business practices have a beneficial effect on the value of a firm and its long-term financial success (Mohammad & Wasiuzzaman, 2021). Companies that actively and strategically manage their sustainability risks and opportunities generally achieve superior financial performance, attract greater investment, and benefit from improved reputations (Nguyen, 2020; Aksan & Gantyowati, 2020). Studies suggest that companies that have good sustainability policies tend to have reduced capital expenses, enhanced operational efficiencies, and increased customer loyalty (Loh & Tan, 2020). These benefits result in a competitive advantage in the market, emphasizing the essential role of sustainability reporting in promoting firm success.

According to Nguyen (2020), while sustainability reporting has gained importance in recent decades, the accuracy and comprehensiveness of research on the relationship between sustainability reporting and market value are still questionable. In other words, the specific mechanisms through which sustainability reporting influences financial performance and firm value are not yet completely understood. Buallay (2020) highlights the lack of cross-sectoral research between sustainability reporting and firm performance. Accordingly, the objective of this paper is to examine the significant influence that sustainability reporting can exert on a firm's financial performance and overall worth.

Analyzing sustainability reporting through a theoretical framework involves understanding the complex relationship between sustainability reporting and its impact on firm value. One major issue is the lack of a universally accepted model, leading to inconsistencies in how sustainability metrics are measured and interpreted. Additionally, the complexity of integrating sustainability into traditional financial frameworks can obscure the true impact of sustainability practices on firm performance. How can existing theories be adapted to better capture the multidimensional nature of sustainability to provide a more comprehensive understanding? This paper investigates the theoretical foundation to understand this relationship.

This paper is organized as follows. The next section reviews the literature on sustainability reporting and its influence on firm value. The third section describes the various models available for the analysis of sustainability reporting and firm value. Following that, the theoretical foundation for the sustainability reporting framework is also presented. Finally, discussions and conclusions are elaborated in the final section. Recommendations are also made on the way forward for sustainability reporting study.

2. Literature Review

The second section reviews existing literature on sustainability reporting. It reviews previous studies, research findings, and conceptual models related to the topic. This section helps establish the knowledge base, identify gaps in the literature, and provide a foundation for proposing a new model or approach.

Mechanisms through Which Sustainability Reporting Influences Firm Value: Studies on sustainability reporting and firm value have continuously shown a favorable correlation between the two, emphasizing various important processes by which sustainability reporting can improve a firm's financial performance and overall worth (Bachoo et al., 2022; Van Linh et al., 2022). The increasing number of studies highlights the crucial significance of sustainability reporting in the current business landscape.

Enhanced corporate reputation is one of the main ways in which sustainability reporting increases the value of a firm. Arora and Gahangopadhyay (1995) assert that one of the motivations for companies to comply with legal requirements is to build and uphold a positive reputation. These laws mandate that companies disclose information to monitor their performance and mitigate information asymmetry (Kim and Kim, 2017).

Companies that openly reveal their sustainability activities are frequently regarded more positively by consumers, investors, and other interested parties (Flammer, 2013). Having a positive perception can result in enhanced consumer loyalty, better revenue, and a more secure investment base (Peloza & Shang, 2011; Bhattacharya et al., 2009). An organization's strong reputation for sustainability can also appeal to highly skilled individuals, as employees are more inclined to seek employment with companies that exhibit a dedication to social and environmental responsibility (Uusi-Rauva & Nurkka, 2010; Staniškienė & Stankevičiūtė, 2018).

Staniškienė & Stankevičiūtė, (2018) conducted a case study for A Lithuanian organisation provided. The study emphasizes the significance of including employees' viewpoints in assessing social sustainability. It emphasizes the crucial importance of employees in assessing an organization's social sustainability and argues for their involvement as they are seen as the organization's main asset. The proposed framework prioritizes six fundamental aspects: employee involvement, employee collaboration, equal chances, employee growth, health and safety, and external alliances. These findings indicate that the viewpoints of employees are crucial in corporate social responsibility (CSR) reporting, as they contribute to a thorough and precise evaluation of social sustainability initiatives.

Derived from a subset of 59 American firms who released their initial independent sustainability report within the time frame of 2001 to 2007, the study conducted by Brown et al. (2009) suggests that, on average, there were no significant alterations in reputational scores. Nevertheless, their research on cross-sectional analysis demonstrates that firms operating in socially vulnerable sectors encountered a decrease in their rankings. In addition, sustainability reporting enhances risk management by aiding organizations in identifying and mitigating potential hazards related to environmental and social factors (Shad et al., 2019). These risks encompass potential penalties imposed by regulatory bodies, liabilities related to the environment, and conflicts arising from social factors that have the potential to disrupt the smooth functioning of commercial operations (Fitriana & Wardhani, 2020).

Hogan and Lodhia (2011) propose that the utilization of reputation risk management helps to explain the underlying incentives for engaging in sustainability reporting. In addition, Hogan and Lodhia (2011) further indicate that the proposed requirements have the potential to decrease the number of sustainability reports while improving their overall quality. In addition, firms can proactively detect new hazards and take advantage of possibilities for continuous improvement and innovation by implementing comprehensive risk management frameworks that are informed by sustainability data. Finally, it can lead to enhanced financial performance and long-term sustainability (Ardiana, 2019).

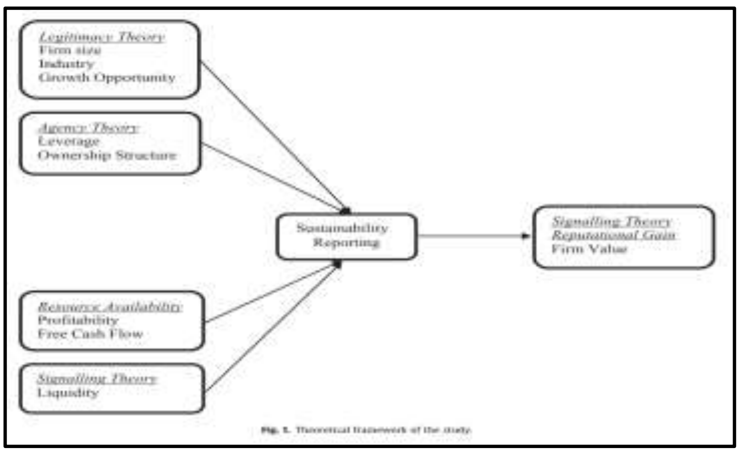
Studies also indicate that companies that participate in sustainability reporting generally have enhanced access to funding (Asogwa et al., 2021; Bellringer et al., 2011). The study of Nwobu (2015) also discovered a positive correlation between sustainability reporting and shareholders' funds. Investors are progressively employing

ESG factors to steer their investment choices, showing a preference for companies that exhibit robust sustainability performance (Berthelot et al., 2012; Martínez-Ferrero & García-Sánchez, 2017). Investors are generally drawn to sustainable firms due to their perceived resilience and advantageous positioning for future growth, which enhances their attractiveness (Permatasari & Narsa, 2022). This can result in a reduction in the cost of capital and an increase in investment inflows, further improving the value of the firm (Shad et al., 2020; Buallay, 2020; Carvalho & Murcia, 2016).

Sustainability reporting also leads to operational efficiencies (Arena & Azzone, 2012). Companies can find opportunities to decrease waste, save resources, and optimize supply chains by prioritizing sustainable practices (Osazefua, 2019). These enhancements not only decrease expenses but also increase the overall effectiveness and durability of operations. Research has indicated that organizations that implement strong sustainability practices tend to have greater profitability and operational performance in comparison to companies that do not prioritize sustainability (Egan, 2019; Kwon & Lee, 2019; Nigri & Del Baldo, 2018).
Moreover, the practice of sustainability reporting has the potential to foster innovation and create fresh avenues for market expansion (Moore & Manring, 2009). Companies that place a high value on sustainability are frequently leading the way in creating innovative products and services that cater to the increasing need for environmentally and socially conscious options (Van Der Waal, et al., 2021). This has the potential to create additional sources of income and stimulate expansion in developing markets that prioritize sustainability.

Models for Analyzing Sustainability Reporting and Firm Value

Figure 1: Model for explaining factors affecting sustainability reporting and its relationship to firm value

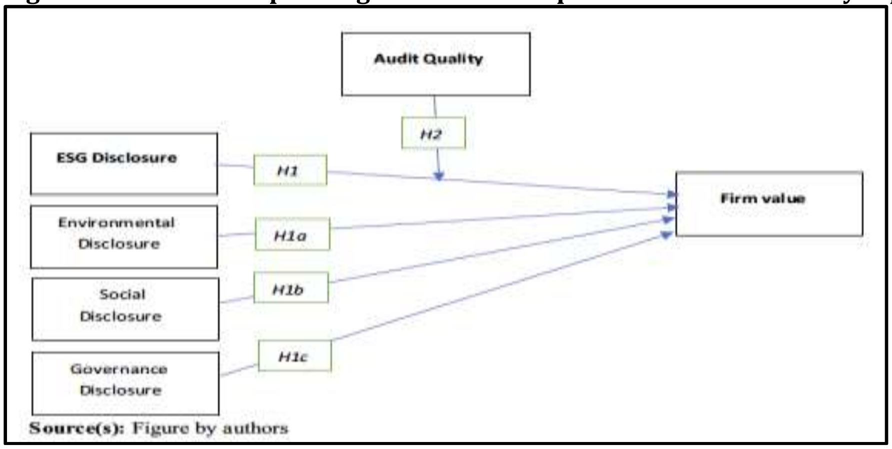


Source: Kuzey and Uyar (2017)

Kuzey and Uyar (2017) examine the factors that influence sustainability reporting and its effect on the firm value in the emerging market of Turkey. The study incorporates many theoretical frameworks, including legitimacy theory, agency theory, resource availability, and signaling theory, to investigate the connections between firm-specific variables, financial resources, and ownership structure in sustainability reporting. The study delves deeper into the impact of sustainability reporting on the firm value, offering valuable information on how transparent sustainability practices can improve a firm's market performance and the trust of its stakeholders. This method emphasizes the various factors and outcomes of sustainability reporting in a developing market.

Through the examination of a representative sample of 297 publicly traded firms on the Borsa Istanbul, Kuzey and Uyar's (2017) findings demonstrated that sustainability reporting has a considerable impact on the firm value. Based on the results, it appears that investors and other stakeholders consider sustainability disclosures to be significant and indicative of a firm's long-term prospects. As a result, they include these reports in their decision-making processes. Hence, it is clear that transparent sustainability policies are extremely important for increasing the market valuation of a firm and boosting investor confidence.

Figure 2: Model for explaining the relationship between sustainability reporting and firm value

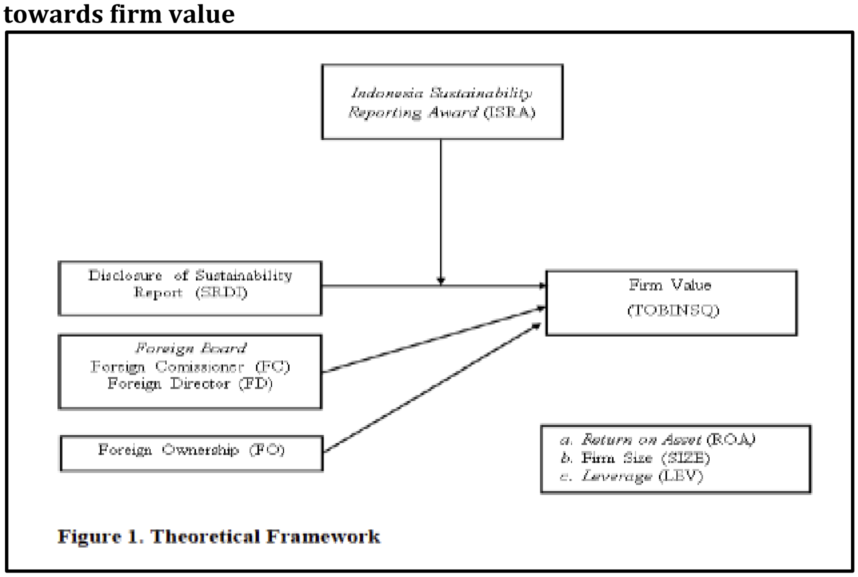


Source: El-Deeb et al. (2023)

El-Deeb et al. (2023) examine the ESG disclosure and firm value with the moderating impact of audit quality. The results suggest that ESG variables have a significantly positive impact on firm value. This highlights the increasing acknowledgment that organizations dedicated to sustainable practices are not only satisfying their social and environmental obligations but also improving their financial success. Companies that actively oversee and disclose information about ESG factors are more likely to draw in additional investors. This is because such activities are increasingly regarded as signs of enduring stability and effective risk control. As a result, organizations that have strong ESG initiatives often have higher market valuations, increased investor trust, and better access to finance.

Moreover, the study highlights the critical role of audit quality as a moderating variable in this relationship. High-quality audits improve the dependability and precision of ESG disclosures, guaranteeing that the information supplied is reliable and thorough. This added layer of assurance enhances investor trust in the firm's disclosed ESG practices, hence strengthening the favorable influence on the firm's worth. Companies can enhance the credibility of their ESG initiatives by adhering to strict audit standards. This allows them to optimize the advantages of sustainability reporting and gain a competitive edge in the market.

Figure 3: Model for explaining the relationship between sustainability reporting and governance towards firm value



Source: Aksan and Gantyowati (2020)

Utilizing stakeholder theory, Aksan and Gantyowati (2020) examine the impact of sustainability report disclosures, the presence of foreign board members, and foreign ownership on firm value. Stakeholder theory posits that firms have a responsibility to fulfill and safeguard the interests of stakeholders in all their commercial endeavors. Stakeholders greatly rely on non-financial information, such as sustainability reports, for making informed decisions. Revealing these reports improves clarity, responsibility, and the trust of those involved (Li et al., 2018).

The study employs the Indonesia Sustainability Reporting Award (ISRA) as a moderating variable to assess the influence of sustainability report disclosures on firm value. Their research suggests that the presence of foreign board members and foreign ownership typically does not have a significant impact on the overall firm value. However, further examination indicates that foreign commissioners in the service and finance industries have a beneficial effect on firm value, and foreign ownership in State-Owned Enterprises (SOEs) also contributes positively to firm value.

3. Theoretical Foundations Used To Examine Sustainability Reporting and Firm Value

According to Nguyen (2020), stakeholder theory and legitimacy theory are the two primary frameworks addressing the importance of sustainability reporting for firm value. Stakeholder theory asserts that the actions of a firm affect the advantages experienced by both the firm itself and the individuals or groups with a vested interest in the firm (Halid et al., 2023). Hence, it is imperative for a firm to consider the interests and requirements of all stakeholders while making choices and taking action (Fuadah et al., 2022). By attending to these interests, companies can enhance their ability to estimate risks, thereby increasing value for both investors and stakeholders.

Sustainability reporting requires a firm to publish information about its economic, environmental, social, and governance aspects, as well as the risks associated with them and the measures to manage those risks (Ballou et al., 2006). This form of reporting provides substantial advantages to both a firm's internal processes and its external stakeholders (Kim et al., 2021). Incorporating social responsibility measures can help a board of directors gain enduring support from stakeholders, thus enhancing the long-term worth of the organization (Rabaya & Saleh, 2022).

Legitimacy theory, on the other hand, posits that corporations possess inherent obligations and implicit responsibilities to society. Companies are frequently involved in sustainability reporting to demonstrate their compliance with society's expectations and adherence to social norms. Cho and Patten (2007) argue that sustainability disclosure functions as a mechanism to validate a firm's actions. Companies engage in this process by selecting crucial indicators, whether from statutory requirements or established standards, to assess their environmental and social performance. By doing this, individuals can efficiently convey their adherence status to society (Deegan & Blomquist, 2006).

Legitimacy is achieved when an organization meets or exceeds existing social values and norms (Long & Driscoll, 2008). Through the creation of clear and comprehensive sustainability reports, companies may showcase their dedication to corporate social responsibility and adherence to ethical business principles (Ali et al., 2021). This level of transparency enhances stakeholders' perceptions of the firm's social responsibility initiatives and overall transparency. Positive perceptions and greater support from stakeholders can greatly enhance a firm's worth.

According to this theory, firms make an effort to synchronize their operations with public norms and expectations to obtain their social license to operate. By actively participating in and transparently reporting on sustainability initiatives, firms exhibit their dedication to ethical conduct, social accountability, and environmental stewardship. This alignment with societal values not only helps in mitigating potential criticisms and regulatory pressures but also enhances the firm’s reputation and credibility among stakeholders. Sustainability practices, therefore, serve as a strategic response to societal demands and expectations. This would allow firms to reinforce their legitimacy, foster trust, and ultimately ensure their long-term viability and success.

Some studies look into the relationship between sustainability reports and firm value from the perspective of signaling theory. Based on 9,077 firm-year observations from 2011 to 2022, Friske et al. (2023) investigate the relationship between voluntary sustainability reporting and firm value, drawing hypotheses from signaling theory. The study finds that sustainability reporting is initially negatively related to Tobin's q. However, over time, this relationship becomes increasingly positive. Friske et al. (2023) conclude that while sustainability reporting may initially serve as a costly signal, it ultimately enhances firm value. This improvement occurs when firms become more proficient at communicating their sustainability initiatives and as investors improve their ability to assess these reports. Signaling theory suggests that the information shared by corporations can sufficiently enlighten investors and guide their investment decisions (Rokhayati et al., 2019; Brown-Liburd et al., 2018; Chen et al., 2021).

Signaling theory offers a valuable framework for assessing the correlation between sustainability reporting and firm value. Signaling theory suggests that firms utilize sustainability reports to communicate their dedication to sustainable practices and corporate social responsibility to stakeholders (Friske et al., 2023). First, the expenses related to creating and distributing these reports may be more than the apparent advantages, resulting in a detrimental effect on metrics such as Tobin's q. Nevertheless, as companies refine their reporting processes and improve the quality and transparency of their disclosures, the market begins to acknowledge and reward these efforts. Over time, investors and other stakeholders gain confidence in the firm's long-term sustainability commitments, leading to an increased firm value (Rokhayati et al., 2019). Therefore, when sustainability reporting is properly conveyed, it serves as a strategic instrument that demonstrates a firm's commitment to ethical standards and its capacity for long-term prosperity, ultimately promoting a favorable influence on the firm's worth. Studies that use corporate governance variables like ownership structure and dividend payout normally employ the signaling theory (Dihardjo & Hersugondo, 2023).

Analyzing the theoretical framework presented in prior studies, it can be summarized that stakeholder theory is normally utilized when analyzing the motives behind sustainability reports. Firms disclose their ESG initiatives as a response to stakeholders' expectations, beyond that of the shareholders. While legitimacy theory provides a compelling explanation for the reasons firms engage in sustainability initiatives, positing that these actions are driven by a desire to legitimize their operations in the eyes of society.

Signaling theory, on the other hand, suggests that corporations who voluntarily reveal their social responsibility efforts strive to communicate to investors that they are adopting long-term initiatives connected to the economy, environment, and social aspects to get long-term benefits.

4. Discussion, Conclusion and Suggestions For Future Research

Overall, the connection between sustainability reporting and the value of a firm is dynamic and influenced by several theoretical perspectives, including stakeholder theory, legitimacy theory and signaling theory. Sustainability reporting has gained significance for firms aiming to improve transparency, accountability, and stakeholder confidence by publishing non-financial information regarding their sustainability practices.

In general, the incorporation of sustainability reporting into corporate operations is motivated by the necessity to fulfill stakeholder expectations for openness and responsibility, as well as the strategic advantages linked to signaling and credibility. Although there may be substantial upfront expenses associated with establishing comprehensive sustainability reporting, the long-term advantages, such as increased investor trust, improved risk control, and enhanced firm worth, highlight the significance of this approach. Both signaling and legitimacy theories offer useful insights into the reasons why companies participate in sustainability reporting and how it eventually enhances their market performance and long-term profitability.

The degree to which sustainability reporting affects the firm value can be affected by several different factors, including the quality of the reports, the environment in which the firm operates, and the particular sustainability concerns that are being addressed Buallay, 2020; Schreck & Raithel, 2018). Ultimately, even though sustainability reporting is widely regarded as an essential component of modern corporate governance, additional research is required to acquire a thorough understanding of the impact that it has on the value of a firm. It is recommended that future studies concentrate on the development of standardized methods and procedures to evaluate the effectiveness of sustainability reporting and provide a more accurate understanding of the financial repercussions of this methodology. Consequently, this will make it possible for businesses and investors to acquire a more profound comprehension of the strategic significance of sustainability practices and the contribution that these practices make to the achievement of long-term commercial success.

Further investigation is needed to examine the dynamic relationship between sustainability reporting and firm value in different geographical regions to account for contextual differences. An analysis of the enduring effects of comprehensive sustainability disclosures on firm valuation would be beneficial, with special emphasis on the reactions of various stakeholders such as investors, customers, and regulators. Additionally, the incorporation of sophisticated analytical methodologies, such as machine learning and big data analytics, has the potential to improve the understanding of the important impacts of sustainability reporting. Additional research might also explore the influence of increasing rules and global standards on the quality and uniformity of sustainability reporting, and how this subsequently affects the value of companies. Finally, conducting comparative studies on firms with varying ownership structures, governance procedures, and market maturity levels would offer a more profound understanding of how sustainability reporting affects firm value and stakeholder perceptions.

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