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Environmental and social disclosures: Link with corporate financial performance

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ABSTRACT

Environmental and social disclosures entail costs, yet increasingly, large listed firms are making higher and better quality disclosures. In this paper we examine the link between a firm's environmental and social disclosures and its profitability and market value. We find that past profitability drives current social disclosures. However, consistent with the existing evidence, we do not find any relation between environmental disclosures and profitability. Further, while prior literature has largely focussed on environmental disclosure, we find that it is the social disclosures that matter to investors. We find that firms that make higher social disclosures have higher market values. Further analysis reveals that this link is driven by higher expected growth rates in the cash flows of such companies. Overall our findings are consistent with the resource based view of the firm and the voluntary disclosure theory, suggesting that firms with greater economic resources make more extensive disclosures which yield net positive economic benefits.

1. Introduction

From an economics perspective, producing objective[1] environmental (E) and social (S) disclosures entail real, proprietary, and opportunity costs (Armitage & Marston, 2008; Brammer & Pavelin, 2006, 2008; Buhr, 2002; Cormier & Magnan, 1999, 2003; Li & McConomy, 1999; Verrecchia, 1983, 2001). Yet, E and S disclosures by large listed companies in the UK (as in many countries around the world, Gray Javad, Power & Sinclair, 2001) have grown phenomenally over the years, rising from approximately a page devoted to employee related disclosure in the 1970s (Gray, Kouhy, & Lavers, 1995, p. 62) to detailed stand-alone sustainability reports issued by many listed companies in recent years. This trend is in line with the growing interest in environmental and social issues on the part of a variety of corporate stakeholders including socially responsible investors, employees, customers, regulators, government (Brammer & Pavelin, 2006, 2008; Clarkson, Li, Richardson, & Vasvari, 2008, 2011; Cormier & Magnan, 1999, 2003; Deegan, 2004; Gray et al., 1995; Gray, Javad, Power, & Sinclair, 2001), as well as the wider society via various environmental and social activist groups (den Hond & de Bakker, 2007). There is a general consensus in the literature[2] that larger, more 'visible' firms and those operating in more environmentally sensitive

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[1] By objective we mean 'hard' disclosures as used by Clarkson et al. (2008), which according to them, are quantifiable performance indicators.

[2] See e.g. Freedman and Jaggi (1988), Patten (1991), Gray et al. (1995), Hackston and Milne (1996), Gray et al. (2001), Cormier and Magnan (2003), Brammer and Pavelin (2006, 2008), Clarkson et al. (2011), and Guidry and Patten (2012).

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sectors are likely to make more extensive E and S disclosures. However, within this literature, the link between profitability and such disclosures remains as yet unclear.

Some scholars, drawing on the socio-political and legitimacy theory based arguments posit and find some empirical support for the notion that such disclosures are driven primarily by public pressure and are aimed at gaining a 'license to operate' from the various corporate stakeholders and the wider society (Hackston & Milne, 1996; Patten, 1991, 2002a; Walden & Schwartz, 1997). Others, consistent with the resource based view (RBV) of the firm (Hart, 1995; Russo & Fouts, 1997) and the economics based voluntary disclosure theory (VDT), (Verrecchia, 1983, 2001) argue that firms with superior environmental and economic performance have the incentives and the resources to convey their 'type' by making more extensive and objective E disclosures. Yet, studies taking this latter view provide less than convincing evidence, especially with respect to measures of economic performance (see e.g. Al-Tuwaijri, Christensen, & Hughes, 2004; Clarkson et al., 2008, 2011; Cormier & Magnan, 2003; Guidry & Patten, 2012). In this paper we revisit the relation between E and S disclosures and profitability as well as investigate the direction of causality, if any, between the two - an issue that prior research has identified as meriting attention (Brammer & Pavelin, 2006, 2008; Gray et al., 1995, 2001).

Within the E and S disclosure literature there is also an ongoing debate as to whether these disclosures are value-relevant. While some scholars theorise and find empirical support for the notion that these disclosures are mainly a 'legitimation tool', (Cho & Patten, 2007; Gray et al., 1995), others, consistent with the RBV and VDT theories, argue and find some empirical support that objective E disclosures are value-relevant (see Al-Tuwaijri et al., 2004; Clarkson, Li, Richardson, & Vasvari, 2011; Cormier & Magnan, 2007, 2013). RBV theorists (Hart, 1995; Russo & Fouts, 1997) argue that superior performance in the environmental arena and its effective communication can confer competitive advantages to the firm, including a strong positive reputation. Highlighting the importance of communicating the responsible environmental strategies of the firm to its external stakeholders, Hart (1995, p.999) states that such effective communication could '*reinforce and differentiate a firm's position through the positive effects of a good reputation*.' Supporting Hart's (1995) theoretical arguments, as well as integrating the legitimacy and VDT based arguments, Cormier and Magnan (2013) find that reliable and relevant environmental disclosures not only enhance a firm's environmental legitimacy but also help analysts make better earnings forecasts. We extend Cormier & Magnan's (2013) work by arguing that such objective and extensive E (and S) disclosures enhance a firm's reputation and bring economic benefits to the firm, including a higher share price.

While Cormier and Magnan (2013) focus on E disclosures, we also consider S disclosures which to date have received relatively scant attention (Cormier, Ledoux, & Magnan, 2011). As with E disclosures, more extensive and objective S disclosures can enhance a firm's reputation (Armitage & Marston, 2008; Hart, 1995) which should also be valued by investors. We further argue that the competitive advantages gained through a strong positive reputation can manifest in the form of enhanced ability of the firm to attract and retain higher quality human capital, higher customer and supplier loyalty, and increased firm sales. Thus, we argue that the effect of such competitive advantages will most likely be reflected in higher growth rates of expected cash flows of such firms. Accordingly, we test whether expected growth rates of the firms' cash flows are impacted by E and S disclosures.

Consistent with the RBV and VDT theory based arguments, we find that more profitable firms with financial resource slack make higher S (but not E) disclosures and higher combined E and S disclosures. We also document a positive link between S (but not E) disclosures and the firm's share price. Moreover, we find the impact on share price to come through higher implied growth rates in the expected cash flows of such firms. While our results are based on the UK's institutional context, these can be of relevance in other institutional settings as well, as we discuss later.

The rest of the paper is organized as follows. Section 2 reviews the relevant literature and presents the main hypotheses that we test. Section 3 discusses the data, variables and the econometric models. Section 4 presents the results. Section 5 details the robustness checks and Section 6 concludes.

2. Literature review and hypotheses development

2.1. Environmental and social disclosures and profitability

While the extent and content of E and S disclosures are believed to vary by time, company, industry, and institutional context (Cormier & Magnan, 2007; Gray et al., 2001), evidence suggests that larger, more publicly visible firms, and those from more polluting industries are likely to make higher disclosures (Adams, Hill & Robert, 1998; Brammer & Pavelin, 2006, 2008; Cormier & Magnan, 1999, 2003; Gray et al., 1995, 2001; Hackston & Milne, 1996; Patten, 1991).

Legitimacy theorists argue that E and S disclosures are driven by public pressure and are aimed at gaining social legitimacy for a firm's operations that create significant environmental and social impacts (see Cho & Patten, 2007; Gray et al., 1995; Hackston & Milne, 1996; Walden & Schwartz, 1997; Patten, 1991, 2002a, 2002b). This view is articulated well by Patten (1991, pp. 297–298) who argues that '*social disclosure is a means of addressing the exposure companies' face with regard to the social environment*', and that '*the social legitimacy of business is monitored through the public-policy arena rather than the marketplace and, as such, the extent of social disclosure should be more closely related to the public pressure variables than the profitability measures.*' In the study of the factors driving the social disclosures of a sample of Fortune 500 companies, Patten (1991) finds support for these arguments. He finds size and industry classifications (which cover the most polluting industries) to be the main factors associated with S disclosures. None of the profitability measures have a significant association with S disclosures. His subsequent studies including Patten (2002a, 2002b) as well as Cho and Patten (2007) are also