

Chapter 5

The Relationship Between ESG Disclosure, Information Asymmetry, Cost of Capital, and Earnings Management

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ABSTRACT

The study investigates the relationship between ESG disclosure, information asymmetry, cost of capital and earnings management in an emerging economy, India. The study uses PLS-SEM for a sample of 183 companies listed in BSE 500 index for a period of ten years from 2014 to 2023. The study finds that higher ESG disclosure leads to decrease in information asymmetry. While ESG disclosure increases the firm's cost of capital. The result also shows that firms with higher ESG disclosure have more social commitment and less chance for doing earnings management. An

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increase in information asymmetry increases the chance for managers to manipulate earnings. Similarly, higher information asymmetry leads to increase investor risk which results in increased cost of capital. Finally, earnings management practice reduces the firm cost of capital.

1 INTRODUCTION

Environmental, Social and Governance (ESG) disclosure has garnered significant attention, fueled by increasing interest from investors, academicians, and researchers alike. The terms ESG disclosure is frequently interchanged with sustainability and CSR disclosures, this study exclusively employs the term ESG disclosure throughout its content. ESG disclosure furnishes the public with detailed insight into a company's performance in areas related with environmental impact, social responsibility, and corporate governance practices, thereby mitigating information asymmetry among certain stockholders. The consequential reduction in information asymmetry plays a pivotal role in shaping the cost of capital and deterring earning manipulation. From the earlier studies, the researcher has found that ESG disclosure, information asymmetry, cost of capital and earnings management are associated with each other. Information asymmetry causes adverse selection problems, lack of investor confidence, reduces market liquidity and increases firms required rate of return (Easley and O'Hara, 2004). Information asymmetry problem arises when some investor has information advantage about firms' operation than other investors. This can be solved by providing information voluntarily, so that information asymmetry could be reduced (Hung et al. 2015). Thus, the level of information asymmetry reduced as a result of ESG disclosure is important in determining its effect on cost of capital and earnings management (Hung et al. 2015). In short information asymmetry acts as a mediator in this interrelationship (Cuadrado et al., 2016). ESG disclosure reduces both information asymmetry and cost of capital (Michaels and Gruning, 2010; Mazumdar and Sengupta, 2005; Khanchel & Lassoued, 2022)

Companies with ESG disclosure are expected to act responsibly by providing quality and consistent financial data and show its obligation towards responsible business practices (Jones, 1995; Kim et al., 2012; Chouaibi & Affes, 2021). ESG disclosure is often used as a mask by managers to cover their unfair business practices through earning management (Choi et al., 2013). Existing studies also show mixed results regarding the ESG disclosure and earnings management relationship (Prior et al., 2008; Choi et al., 2013; Muttakin et al., 2015; Alsaadi et al., 2017; Gaio et al., 2022). One line of research indicates that firm with higher ESG disclosure provides better financial disclosures and reduces the chance for any sort of accounting manipulation (Alsaadi et al., 2007; Choi et al., 2013; Rezaee & Tuo, 2019).

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