


Chapter 6

Theoretical Underpinnings of Sustainability Reporting and Financial Performance: Focusing on Stakeholder Theory and Legitimacy Theory

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ABSTRACT

This chapter is a discussion of the relationship between sustainability reporting and financial performance based on the Stakeholder and Legitimacy theories. It

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concludes that quality of disclosures as opposed to quantity affects financial performance measures such as ROA and ROE favourably. The Stakeholder Theory is concerned with trust and interaction whereas the Legitimacy Theory is based on acceptance by the society. The empirical evidence indicates mixed results in all sectors, firm size, and regions and SMEs in the emergent economies have peculiar issues. The research accentuates that the lack of standard measures, mechanisms of integration, and long-term works is required. It determines that the alignment of the sustainability reports to stakeholder and legitimacy expectations is a way of adding value to financial output and corporate reputation.

1. INTRODUCTION

Sustainability reporting has taken the centre-stage in the modern disclosure in the corporate world mainly due to the increasing expectations about the issues surrounding the stakeholders, intensifying regulatory demands globally and growing concerns about both the range of environmental risks, the extent of social risks and the nature of governance risk. The companies in the modern world are not only supposed to create financial value but also demonstrate responsible behavior to society and the environment (Gesso & Lodhi, 2024). With reporting systems like the Global Reporting Initiative (GRI), the Integrated Reporting, and the ESG metrics becoming more institutionalized, sustainability reporting is gradually being viewed as a strategic tool of corporate responsibility and the establishment of long-term value. However, even after extensive implementation, there have been concerns related to the credibility, incentives and financial consequences of sustainability disclosures.

The constant problem of the sustainability reporting debate is the one that sparks an unresolved controversy: even though some studies report positive benefits of ESG reporting in the form of higher profitability, market value, and trust investor (Velte, P. 2021; Friede, Busch & Bassen, 2015; Widyawati, 2020), others highlight inconsistent or even negative financial reporting, especially in particular markets, in developing economies, or of voluntary reporting (Buallay, 2019; Clarkson et al. 2023). Additionally, actions driven by legitimacy which include symbolical revelation, selective disclosure or green washing undermine the reliability of sustainability reports (Lee and Raschke, 2023; Arvidsson, 2018). These contradictions lead to difficulties with the determination of whether sustainability reporting actually enhances the performance of firms, or simply acts as a stakeholder perception management tool.

This theoretical muddiness identifies the more fundamental gap in the body of literature: despite the empirical literature on sustainability reporting and financial performance being quite strong, the theoretical explanations are often confusing or contradictory. The Stakeholder Theory and the Legitimacy Theory are regularly

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