The Effect of Stakeholders on Sustainability Disclosure Quality: A Theoretical Framework

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As sustainable business practices continue to gain prominence in the corporate landscape, stakeholders play a pivotal role in influencing organizations' commitment to sustainability disclosure. This paper proposes a stakeholder theory-based model to examine how stakeholders influence firms' sustainability disclosure quality. The framework includes board composition, capital structure, ownership structure, and culture as key variables. Size, industry affiliation, profitability and growth opportunities are considered, with firm-specific characteristics as control variables.

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1 Introduction

As firms experience economic and technological growth, they often face scrutiny regarding their social and environmental impacts. The emphasis on transparency and accountability has driven the need for firms to disclose information about their sustainability initiatives, enabling stakeholders to assess their social and environmental performance. The increased public interest in sustainability issues has prompted the development of various legislative regulations all over the world (Minutiello & Tettamanzi, 2022). While some regions have legislative requirements for firms to make disclosures, it is worth noting that in many parts of the world, firms engage in voluntary disclosure practices. However, the credibility and reliability of such reports have received extensive criticism in the literature indicating that there is a lack of relationship between the quality of disclosure and sustainability reporting practices (e.g. Landrum & Ohsowski, 2018). Rather than being used as a tool for accountability, such reporting is seen as a means of protecting or saving corporate image. While firms' disclosures are anticipated to facilitate decision-making, the approaches to reporting are becoming increasingly diverse (Velte & Stawinoga, 2017). Although there have been initiatives (for instance, UNGC Principles, OECD Guidelines for Multinational Enterprises, Global Reporting Initiative Reporting Framework, ISO 26000, AA1000) to propose appropriate reporting framework, there are still questions about the quality of the information shared.

Previous research has focused primarily on the quantity of disclosure (Al-Tuwaijri et al., 2004; Cho & Patten, 2007; Clarkson et al., 2011), while only a limited number of studies have examined the topic of disclosure quality (Melloni et al., 2017). However, findings have presented conflicting outcomes, highlighting the need for additional research to obtain a more comprehensive understanding of the quality of sustainability reporting regarding nonfinancial aspects such as managerial attitudes and culture (e.g. Hahn & Kuhnen, 2013). According to stakeholder theory, which argues that the primary purpose of business is to create value for all stakeholders, businesses should consider and prioritize the interests of all stakeholders, not just shareholders, in all processes (Freeman, 1984). Indeed, sustainability reporting plays a vital role in enabling stakeholders to make informed decisions regarding the sustainability performance of firms. In this context, the concept of quality disclosure in sustainability reporting becomes crucial.

Within the scope of this study, we seek to answer to what extent stakeholders have an impact on the sustainability disclosure quality, that is transparent and accountable disclosure of sustainability practices. Considering the stakeholder theory, we aim to propose a framework to comprehend how stakeholders affect sustainability reporting quality of the firms. Accordingly, we assumed four main dimensions, specifically i) capital structure, ii) ownership structure, iii) board composition, iv) culture. Each dimension represents "creditors", "shareholders", "management" and "employees, customers and suppliers" respectively. Firm-specific characteristics consisting of size, profitability, growth opportunities and industry affiliation is considered as control variables.

The remainder of the paper is organized as follows. Studies on sustainability disclosure quality are discussed in the second section. Theoretical framework including the theory explaining sustainability practices, and variables used in the framework are explained in the third section. The study ends with conclusion.

2 Sustainability Disclosure Quality

Sustainability reports are the primary channel for communicating a firm's social and environmental impact. In practice, the financial report of a firm has a limitation in that it does not encompass information pertaining to non-financial aspects of firm activities. Thus, firms address these issues in their annual reports or through complementary reports (Martínez-Ferrero et al., 2015). It has grown in popularity and the frequency of information disclosure has increased significantly (Martínez-Ferrero et al., 2015). However, sustainability disclosure can, instead, serve as a mere facade for the firms to create an illusion of transparency and accountability essentially maintaining a "cosmetic behavior" (Di Vaio et al., 2023). Moreover, there are significant differences in the quality of sustainability reporting between firms, which can make it challenging for stakeholders to evaluate the sustainability performance of businesses since it is prepared on a voluntary basis and there are no standard models.

The existence of research directions to examine the quality of sustainability reporting in the literature makes it valuable to address the issue (Dewi et al., 2023). When analyzing these voluntary disclosures, where the subjective perspectives of the author(s) and the opinions of managers come into play, there is often a predominant

focus on the quantitative aspects. This emphasis on quantitative features can sometimes overshadow the quality of the information being shared. In particular, there is a need to clarify how information is disclosed rather than what is or is not disclosed since firms may choose to withhold unfavorable information below a certain threshold level of disclosure, thus sustainability reporting necessitates the establishment of specific reporting examinations (Hummel & Schlick, 2016).

As indicated by Hummel and Schlick (2016), quantity of classified sustainability disclosure items is major concern in previous studies. Rather, how information disclosed should be illuminated. Quality should lie in how the information disclosed changes stakeholders' knowledge of the firm's business strategy (Brammer & Pavelin, 2008). However, designing and implementing a sustainability report that meets the needs of these diverse stakeholders is an intimidating task. Previous studies have predominantly focused on disclosure quantity (Al-Tuwaijri et al., 2004; Cho & Patten, 2007; Clarkson et al., 2011), with limited attention to quality (Melloni et al., 2017). This has resulted in contradictory findings, highlighting the need for more comprehensive understanding of sustainability reporting quality and emphasizing the lack of research on determinants such as managerial attitudes and culture as asserted by Hahn and Kuhnen (2013). Hence, our intention is to propose a framework to comprehend how stakeholders affect sustainability reporting quality of the firms.

3 Theoretical Framework

We build our assumptions based on stakeholder theory proposed by Freeman (1984) in this study. Freeman (1984) defined stakeholders as shareholders, all individuals and groups associated with firm objectives. Stakeholder theory is based on three main pillars: the descriptive approach, which aims to define the behavior among stakeholders; the normative approach, which addresses the responsibility, ethics, and moral obligations of corporate behavior; and the instrumental approach, which focuses on engaging and interacting with stakeholders directly and indirectly (Bailur, 2006). These pillars collectively contribute to a comprehensive understanding and application of stakeholder theory. In particular, the last approach points to the interdependence of resources in achieving goals, making stakeholder theory an important tool for corporate sustainability practices.

Sustainability reporting can have positive and negative implications considering stakeholder theory. Stakeholder theory argues that stakeholders provide significant resources for firms, and in return, firms are expected to meet the expectations of their stakeholders. Therefore, sound relationships with the stakeholders should be formed (Wang et al., 2016). Aware of such power, stakeholders prioritize firms that conduct operations that have a positive environmental and social effect. The critical issue here is that stakeholders need to find firms reliable in sustainability practices (Mcwilliams et al., 2006). Therefore, sustainability reports can be expressed as an important strategic tool that requires establishing strong relationships with stakeholders.

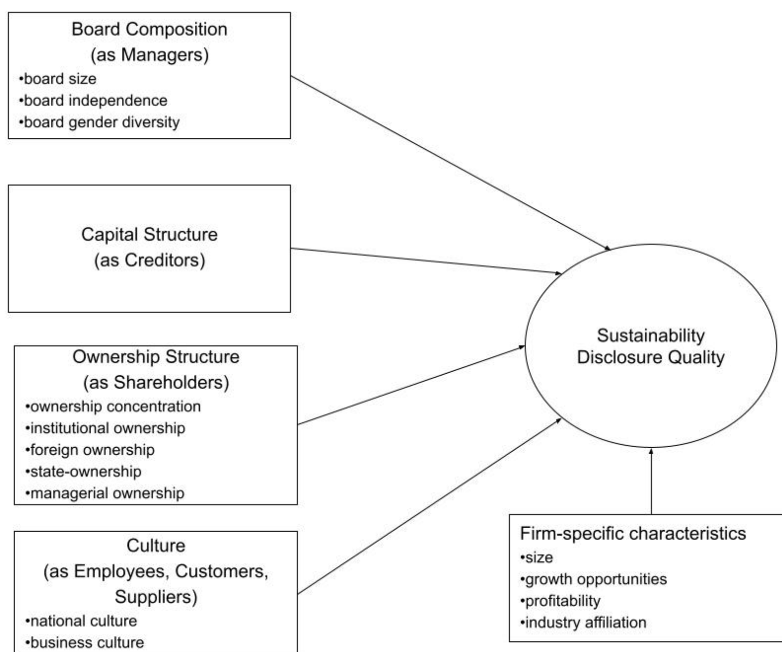

Figure 1: Theoretical framework

The conceptual framework we developed to determine the extent to which stakeholders influence the sustainability disclosure quality is illustrated in Figure 1. Accordingly, capital structure representing creditors, board composition representing the management, ownership structure representing shareholders and finally culture representing employees, customers and suppliers are the variables that we consider to be influential on the sustainability disclosure quality. As control

variables, we consider firm-specific characteristics such as size, industry affiliation, profitability, and growth opportunities.

3.1 Sustainability disclosure quality as a dependent variable

Stakeholder theory emphasizes the importance of considering and meeting the expectations of various stakeholder groups in achieving sustainable and responsible business practices. There is no consensus in the literature on high quality reporting disclosure. Although there seems to be a certain standard on how earnings are reported in mandatory disclosures, approaches to measuring quality in voluntary disclosures generally consist of ranking or self-constructed measurement methods. In particular, the question of whether a standard can be established for the latter approach is at the center of research stream recently (Hummel & Schlick, 2016). In quality measurements, it is common to use environmental and social scores by considering GRI guidelines (Al-Tuwaijri et al., 2004; Clarkson et al., 2008; Martínez-Ferrero et al., 2015). This approach helps stakeholders compare and benchmark firms' sustainability efforts and encourages firms to improve their sustainability practices. GRI (Global Reporting Initiative) offers sustainability reporting standards that guide organizatins in effectively communicating and demonstrating accountability for their environmental, economic, and social impacts, thus serves as a facilitator for transparency and dialogue between firms and their stakeholders.

3.2 Independent Variables

Extensive research has been conducted on the correlation between corporate governance and the disclosure practices of organizations (e.g. Amran *et al.*, 2014; Correa-Garcia *et al.*, 2020 Amran et al., 2014; Dewi et al., 2023). Numerous firms establish a new framework for sustainability and corporate governance by integrating a proactive commitment to sustainable business practices into their corporate identities (Sneirson, 2009). However, the role played by the board of directors in driving the sustainability agenda remains unclear. Therefore, we intend to understand the impact of the board of directors on sustainability reporting disclosure quality. Accordingly, board composition specifically board size, board independence, board gender diversity considered as proxies in line with Amran et al. (2014). A well-functioning board enhances sustainability reporting quality by curbing opportunistic behavior and promoting transparency through diverse membership.

Independent directors and female representation further bolster accountability and inclusivity, thereby improving the overall quality of information disclosed (Hahn et al., 2015; Correa-Garcia et al., 2020).

Extensive research indicates that culture has a significant impact on managerial decision-making (e.g. Hofstede, 1980). There is a clear link between cultural dimensions and stakeholders' preferences and actions as depicted by Tsakumis (2007). Specifically, firms that comprehend and adjust to customers' cultural norms, values, and communication styles are likely to establish trust and loyalty.

The establishment of the balance and its positive reflection on the corporate performance could be expressed as an important driving force of ownership structure. Specifically, Shleifer and Vishny (1986) stated that institutional investors can keep managers under discipline due to their high capabilities such as monitoring and intervention. Ownership concentration provides insights into shareholder control over corporate activities, with decreased concentration typically correlating with increased pressure for public accountability (Ghazali, 2007). Foreign ownership emphasizes long-term goals, necessitating greater transparency in sustainability disclosures (Ananzeh et al., 2023), while state ownership and managerial ownership have varying effects on disclosure quality, with stakeholder theory highlighting the importance of accountability in shaping sustainability practices (Eng & Mak, 2003; Ghazali, 2007). These ownership dynamics underscore the significance of including ownership structure in the developed framework for assessing sustainability disclosure quality.

Given that capital structure decisions play an important role in corporate stakeholder strategy, creditors stand out as stakeholders whose influence must be managed effectively, and managers are expected to meet their expectations for the firm's sustainability practices and prioritize transparency. However, empirical results are mixed. Clarkson et al. (2008) found a positive correlation between leverage and voluntary disclosures, while Bramer and Pavelin (2006) found negative relationship and Clarkson et al. (2011) found no significant relationship between the two variables. In this context, we included capital structure representing creditors into our framework.

3.3 Firm-Specific Characteristics as Control Variables

Larger firms have a greater influence, leaving a more significant impact, and consequently, they attract more attention, becoming more visible in the business landscape. As a result, these firms face heightened scrutiny and increased pressure from stakeholders (Gallo & Christensen, 2011). Larger organizations tend to prefer formal channels of communication to disseminate information about their activities. They recognize the importance of structured and specialized means of sharing information to ensure transparency and effectively communicate their initiatives to stakeholders (Brammer & Pavelin, 2008). Firms operating in industries with significant social and environmental impacts often find it necessary to engage in sustainability reporting driven by the sector-specific stakeholder pressure they face (Parsa & Kouhy, 2008). Moreover, sustainability disclosure within sectors can be influenced by mimetic tendencies, where firms imitate the reporting practices of their industry peers (Husillos et al., 2011). The assumption is that higher profitability provides the financial resources and resilience necessary to support sustainability reporting efforts and navigate any negative impacts that may arise from such disclosures (Kent & Monem, 2008). It is widely acknowledged that voluntary disclosure can help mitigate information imbalances (Clarkson et al., 2008). it is anticipated that firms with the most promising growth prospects would exhibit greater levels of sustainability disclosure.

4 Conclusions

In this study, we propose a model from the perspective of stakeholder theory on the extent to which stakeholders have an impact on the sustainability disclosure quality of firms. According to the developed framework, board composition representing the management mechanism on sustainability disclosure quality is taken into consideration. In this context, board size, board independence, board gender diversity are considered as relevant proxies. Capital structure proxied by leverage is taken into account to represent creditors. Ownership structure is considered as another variable that has an impact on sustainability disclosure quality representing shareholders. Ownership concentration, institutional ownership, foreign ownership, state ownership and managerial ownership are considered as relevant proxies. Finally, culture is also included in the model to represent firm employees, customers, and suppliers. National culture and business culture are also emphasized as relevant

proxies. Firm-specific characteristics as size, industry affiliation, profitability and growth opportunities are considered as control variables.

Testing of the model is envisaged to be carried out in the next stage. Accordingly, a longitudinal, or panel, data analysis that follows the sample of aforementioned factors could be considered as proper methodology. Also, developing countries stand out as a very suitable sample. Given that previous studies have predominantly focused on analyzing sustainability reports from developed countries as noted by Bachoo et al., (2013), examination of firms considering developing countries will lead to valuable insights. Developing countries, which play a key role in global industrial production, are under increasing pressure for economic and social sustainability, particularly on environmental issues. Maintaining competitiveness and accessing global markets requires compliance with international regulations. Accordingly, greener technologies and practices are needed in developing countries. Steps taken in this context encourage technological innovation, cost savings, improved market reputation and less environmental damage.

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