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"Mandatory CSR Disclosure and CSR Performance: an Investigation of European Companies. "

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Firma dello studente

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Summary

Introduction.

The European Commission, in its well-known 2001 *Green Paper on Corporate Social Responsibility,* described CSR as a "concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis." This definition perfectly fits the CSR context at the very beginning of the 21st century, when a flow of companies' efforts in CSR was driven by a renewed awareness of responsibility towards society and the environment, which remained unfulfilled by governmental institutions (Ioannou and Serafeim, 2017).

However, since 2011 the Commission has started developing a different conceptualization and application of CSR, including also mandatory aspects. The great novelty introduced in 2011 consists in the legitimation of the role of public authorities in supporting CSR "through a smart mix of voluntary policy measures and, where necessary, complementary regulation" (European Commission, 2011). Such a great change in the European context proves that CSR is a concept in continuous evolution, implying that "its content evolves and shifts over time depending on changes in the degree of risk, regulation, reputational challenge, and standards of desirable behavior" (Baxi, 2005).

The objective of my work is to investigate one specific mandatory CSR aspect introduced by the European Commission, together with the European Parliament, in its renewed 2011/14 CSR strategy. The mandatory CSR disclosure has been introduced with the EU Directive 95, addressing a number of public-interest entities which exceed the threshold of 500 employees. The targeted companies have to publish CSR-related information on a consolidated non-financial statement starting from fiscal year 2018.

Previous literature on the imposition of CSR disclosure shows different advantages and disadvantages for firms complying with such regulation and, consequently, increasing their CSR disclosure. Increasing data availability to the public can signal their commitment to transparency and their willingness to be socially responsible. In this regard, past studies document that firms with higher ESG disclosure enjoy benefits in terms of brand and reputation or access to finance (e.g. Bhattacharya and Luo, 2006; Cheng *et al*., 2014). Richardson and Welker (2001) have also provided evidence that socially aware investors are willing to pay a premium for the securities of socially responsible firms. On the other side, Chen, Hung and Wang have found a negative economically significant shock for firms subject to mandatory CSR reporting, with a profitability deterioration in terms of *ROA* and *ROE*.

However, only few researchers have already questioned whether CSR disclosure mandates have real positive effects on the firm CSR performance. Although such mandate does not require any changes in firm behavior, Chen, Hung and Wang (2018) developed the hypothesis that

mandatory disclosure impacts a firm's activities because the increased transparency can make it easier for governments and interest groups to pressure firms to engage in more CSR activities. Confirming this hypothesis, they found that the 2008 Chinese CSR disclosure regulation had a diminishing effect in industrial wastewater and SO2 emission, which together represent a measure for the environmental performance of firms subject to the mandate.

The European CSR regulatory framework has represented an interesting ground to raise my research question on whether the EU CSR disclosure mandate has had a positive impact on firms' CSR performance. I answered this research question through an OLS regression model, which was performed over a 3 year time frame, with a sample of firms composing the S&P Europe 350 Index. Their ESG performance is measured by different Thomson Reuters ESG scores, while the application of Directive 2014/95/EU is represented by an explaining dummy variable, which assumes a value equal to 1 in the only one year of regulatory application 2018.

The thesis is structured as follows.

Chapter 1 analyzes the main cases of CSR-related regulations introduced by the governments of various worldwide countries. As these cases focus on regulations mandating different aspects of CSR in different social backgrounds, both positive and negative aspects associated with the imposition of CSR emerge in chapter 1. What mostly emerges is that CSR is moving beyond the voluntary aspect which was still predominant few years ago. In more recent years, indeed, growing social (e.g., poverty, deteriorating social equality, and corruption) and environmental (e.g., climate change, water usage, and waste) challenges have generated renewed pressures on companies by investors, shareholders and a wide range of stakeholders to adopt a more systematic approach towards risk management and sustainability reporting.

Companies are increasingly expected to disclose how they are utilizing, developing (or depleting) and, more generally, affecting human capital, natural resources and society at large (Ioannou and Serafeim, 2017). Therefore, mandatory CSR disclosure may contribute to mitigate information asymmetry between internal and external stakeholders, thanks to an improvement in the non-financial reporting quality.

The last paragraph of chapter 1 introduces the European CSR context and provides a detailed explanation of the European Directive, which brings to formulate my research question after a review of the relevant related literature.

In the second chapter I provide an answer to my research question through multiple OLS regression models, where I use an explaining dummy variable to represent the application of Directive 2014/95/EU in each of the observation years 2016 to 2018. Thomson Reuters ESG Combined Score and some of its score components are regressed on the dummy variable *eudir* and other control variables of different nature.

As the study results don't reflect my initial positive expectations, I finally provide some possible explanations to the outcome, also showing the limitations of my regression model.

1. Mandatory vs Voluntary Corporate Social Responsibility: Initiatives and Related Literature.

1.1 Literature review: research methods and inclusion criteria.

Two specific inclusion criteria have been used to select the articles taken into consideration for this work. The first criterion is based on the source: the articles have been selected from reliable sources which are EBSCO and Scopus, both belonging to "Sistema Bibliotecario di Ateneo" of "Università degli Studi di Padova", whose other international Economics databases have also been used to look for relevant literature. Google Scholar has been used as a supplementary source of articles because the articles regarding some CSR-related topics are more consistently indexed on this search engine than on the previously cited sources.

The second criterion is based on articles rating: each article rating has been double-checked on *Budget Integrato Ricerca Dipartimentale (BIRD) 2018,* published by "Dipartimento di Scienze Economiche e Aziendali M. Fanno", and *Academic Journal Guide (AJG) 2018* published by "Chartered Association of Business Schools". Specifically, the articles included have at least a ranking of B, on a range from A to E, according to BIRD and/or at least a ranking of 3 according to AJG, on a range from 4* to 0.

All the articles not complying with both the aforementioned criteria were excluded from this study.

At the beginning of the preparatory works, the articles have been found through a combination of generic key words, such as "corporate sustainability CSR". As a thesis idea started taking a clearer shape, the key words employed changed to catch different CSR aspects which have been adopted in a voluntary as well as a mandatory form. Thus, "voluntary mandatory CSR" words have been used first in the research of interesting cases of CSR regulations enacted all over the world, and in a second moment more articles regarding a specific country CSR regulation have been looked for through words combinations such as "mandatory CSR India" or "mandatory CSR disclosure China". At last, the literature research was all led towards the European Directive, therefore some related words have been mixed together in various ways, for example "CSR directive Europe", "Directive 2014/95/EU" or simply "CSR Europe". However, as few valid articles were available for this last topic, the sources of information mostly used consisted in different pages of the European Union official website.

1.2 Voluntary and Mandatory CSR Disclosure.

Around the world, the number of companies that have developed governance processes to measure, analyse and communicate sustainability efforts has dramatically increased in the last few years. This trend only partly manifests because of voluntary actions by individual companies, while in many cases it is the result of a proliferation of reporting regulations aiming to incentivize companies to improve their environmental, social and governance (ESG) performance (Gatti *et al*., 2018).

Firms might increase disclosure as a response to the regulation and/or the fear of being found not compliant, or because they might perceive benefits generated through compliance. The signalling theory suggests that firms whose goal is to signal that they are "good corporate citizens" will further increase disclosure, assuming that competitors will also be forced to increase their own disclosure because of the regulation (Verrecchia, 2001). Similarly, if disclosure regulations raise the perceived importance of ESG issues in society, firms could increase data availability to signal their commitment to transparency, their willingness to be responsible and accountable, and to conform to societal norms and expectations. In fact, past studies document that firms with higher ESG disclosure enjoy benefits in terms of brand and reputation or access to finance (e.g. Bhattacharya and Luo, 2006; Cheng *et al*., 2014).

However it's reasonable to expect that not all the firms will increase their ESG disclosure after a regulation comes into force, for three main reasons: first, many sustainability disclosure regulations contain a "comply or explain" provision (Gatti et al., 2018; Ackers and Eccles, 2015); second, in contrast to financial reporting, it is not clear what the potential sanctions resulting from non-disclosure would be (Ackers and Eccles, 2015). The third and most substantial reason is that, as a rich literature on reporting incentives shows (i.e. Ioannou and Serafeim, 2017), mandatory sustainability disclosure regulations can inflict various types of economic losses on the shareholders of the companies subject to the mandate; for example firms with superior sustainability disclosure will have to exert greater efforts and possibly incur higher costs to distinguish themselves from the rest of the firms in the period following the regulation.

On the other hand, multiple studies have found that CSR activities, if voluntarily disclosed, provide a number of benefits to a firm's stakeholders, including increased employee morale, a better firm reputation, and more harmonious growth (i.e. Edmans, 2012; Servaes and Tamayo, 2013). Anecdotal evidence also indicates that firms' reputation and long-term sales can suffer because of poor CSR performance (Dhaliwal *et al*., 2011). A well-known example is Nike, which struggled for years and invested a great amount of financial resources and effort to regain its reputation after the 1997 child labor scandal.

Besides the reputation improvement, other incentives exist for a firm to voluntarily disclose its CSR activities. Dhaliwal, Li, Tsang and Yang (2011) examined previous literature, finding out that a company's enhanced financial disclosure relates to a decrease in its cost of capital through mechanisms that equally apply to non-financial disclosure. Among these major mechanisms we can include the increase in the investors' awareness of a firm's existence and the enlargement of its investor base (Merton, 1987), together with a reduced information asymmetry among investors or between managers and investors, equally giving as a result a decrease in the cost of equity (Lambert *et al.*, 2007).

In the aforementioned study (Dhaliwal *et al.*, 2011), 294 US firms were analysed, mainly all firms in the S&P 500 and Domini 400 Social SM Index, that voluntarily issued a total of 1190 standalone CSR reports between 1993 and 2007.

The Hypothesis that CSR disclosure leads to a lower cost of equity capital was tested through a regression model, with Cost of Capital variation as the dependent variable and CSR Disclosure as the explaining one. Previously, another regression model was created where a group of firms voluntarily initiating CSR disclosure was compared with a non-initiating group. The results show that, consistent with the theory on voluntary disclosure, firms voluntarily publishing standalone CSR reports tend to have superior CSR performance relative to their industry peers. The control variables also prove that firms initiating CSR disclosure are significantly larger (higher market value of common equity), more profitable (higher ROA) and have a higher degree of leverage than non-initiators. The 2011 study continues by investigating on some of the underlying mechanisms through which voluntary CSR disclosure lowers the cost of equity capital. Dhaliwal *et al.* (2011) found that initiating firms with CSR performance superior to that of their industry peers enjoy a reduction in the cost of equity capital as they attract dedicated institutional investors and analyst coverage, and these analysts achieve lower absolute forecast errors and dispersion following such disclosure.

Such mechanisms, that make non-financial disclosures affect firms' financial performance, are similar to those activated by non-financial disclosure. Other than this type of mechanisms, however, CSR practices have additional possible channels to positively affect firms' financial performance. For instance, socially aware investors are willing to pay a premium for the securities of socially responsible firms (Richardson and Welker, 2001). Perhaps more importantly, some CSR projects have direct implications for positive cash flow even in the near future. For example, practices related to protecting the environment and improving employee welfare can reduce potential litigation and pollution cleaning costs, boost employee morale and, thereby, the production efficiency (Dhaliwal *et al.*, 2011).

All the arguments above are based on the assumption of voluntary CSR policies, which have for sure multiple positive aspects, but they have also received various criticisms. Among the main ones we can consider the promotion of free-riding behaviour (O'Neill, 2007), the impossibility of sanctioning transgressors (Cominetti and Seele, 2016) and the problems related to the level of transparency and credibility of voluntary CSR reports (Lock and Seele, 2016). On the contrary, a mandatory system may facilitate the establishment of regulated and comparable CSR indicators that finally benefit the whole nation (Horrigan, 2007).
However, the opinions from the academic world are not homogeneous even regarding mandatory CSR disclosure. Critics of sustainability disclosure regulations argue that companies that are "forced" to increase disclosure will bear significant costs either because of the disclosure *per se* or because of the changes in managerial practices that they will be forced to make, thus destroying shareholder value. In contrast, supporters of mandatory CSR disclosure argue that firms that increase disclosure will benefit in terms of enhanced corporate reputation and superior brand value, recruitment and retention of employee talent, uncovering of opportunities to improve process efficiency and management of hidden risks, better access to finance, among multiple other reasons (Ioannou and Serafeim, 2017).

Ioannou and Serafeim (2017) conducted a research on data collected from four countries (China, Denmark, Malaysia, and South Africa) that had mandated sustainability disclosures prior to 2011. This was the first attempt to investigate the effect of disclosure regulations that mandate sustainability reporting on firms' disclosure practices. Their objective was to understand whether firms subject to sustainability disclosure mandate had increased ESG disclosure following their respective regulation. The research was carried out through a differences-in-differences analysis to estimate the impact of the regulation on treated firms, using two alternative control groups from the rest of the world. The data was collected from Bloomberg, that calculates an ESG Disclosure score and its three sub-scores (Environmental (E), Social (S) and Governance (G)) to quantify a company's transparency in reporting ESG information. By applying the criteria that each respective regulation stated, Ioannou and Serafeim identified 144 Chinese, 29 Danish, 43 Malaysian, and 101 South African treated firms, which are among the largest firms in each of their respective economies. They used two different samples to control for other inter-temporal changes in ESG disclosure: a global set of control firms and a group of U.S. firms only. The second control group is the most appropriate since, compared to other countries, in the U.S. relatively fewer ESG-related disclosure regulations have been adopted between 2005 and 2012.

With an ordinary least squares (OLS) regression model they estimate the effect of the disclosure regulations on ESG reporting through the employment of the explaining dummy variable $Treatment_i$ *x* $Mandate_t$. $Mandate_t$ is an indicator variable capturing whether in year *t* the regulation mandates disclosure of ESG information and zero otherwise, whereas $Treatment_i$ takes the value of one if firm *i* is covered by the regulation and zero otherwise. Furthermore, they control for key time-varying firm characteristics that are likely to be correlated with disclosure levels: firm size and leverage.

The result is a positive coefficient of the $Treatment_i$ *x* $Mandate_t$ variable, therefore consistent with an increase in disclosure following the regulation. This finding indicates that treated firms had significantly increased ESG disclosure following the regulation, relative to the worldwide control group, with efforts to improve the comparability and credibility of the disclosed information.

What emerges from this study is among the most positive aspects and effects of CSR. On the other hand, other researchers have investigated different mandates regarding the CSR matter, not necessarily obtaining similar positive results. Especially in the last decade, in fact, there have been a few countries that have contradicted the traditional CSR definition, exclusively focused on the voluntary nature of CSR, to regulate one of the different Corporate Social Responsibility aspects.

In the next paragraphs I will briefly analyze some other interesting cases of CSR regulations adopted by various countries from all around the world, together with reviewing studies that analyse their positive or negative effects, on the companies concerned.

1.3 Indian Case: Mandatory CSR Expenditures, CSR committee and Shareholder Value.

India represents one of the strongest examples of recent integration between mandatory and voluntary CSR dimensions. For the first time in the world a legislative mandate is forcing a set of targeted firms to spend funds on certain forms of Corporate Social Responsibility activities (Manchiraju and Rajgopal, 2017). Clause 135 of the Companies Act (2013) requires a firm, which meets any threshold of 5 bln Rupees net worth, 10 bln Rupees turnover or 50 mln net profit on any fiscal year, to spend 2% of its average net profits of the prior three years on CSR activities. Those firms are also required to constitute a Corporate Social Responsibility Committee that is in charge of formulating and recommending to the Board a Corporate Social Responsibility Policy**,** including the activities to be undertaken by the company and the amount of expenditure to be incurred on them.

Section 135 is supplemented by two additional sets of provisions: the first one is Schedule VII, an appendix to the CA which lists desirable CSR activities. The second one consists in the

Corporate Social Responsibility Policy Rules 2014, adopted subsequently by the Minister of Corporate Affairs and included in the CA Section 469. The CSR Rules delineate the categories of companies subject to Section 135, the modalities of implementation of the CSR activities, and the composition of the CSR committee.

The *ratio legis* of this unique provision, which went into effect on April 1, 2014, is to fight growing income inequality in the Indian liberalized economy and to ensure a better distribution of wealth in the communities in which firms operate. Indeed the legislature strongly recommends that companies assign priority to projects that have a local impact. However, Section 135 is deemed a so called *lex imperfecta*, as the CA does not prescribe any penalties for a company that fails to spend the required amount on CSR activities (Gatti *et al*., 2018). Given its nature of comply-or-explain duty, the only obligation for a firm violating Section 135 is to specify in the board's annual report the reasons for not having respected the threshold of CSR expenditures.

The introduction of such a peculiar law addressing Indian companies is attributable to the country's critical social and environmental context. The World Bank Report (2009) states that the "below poverty line" ratio in India is still significant, with 26% of people living in urban areas and 28% in rural regions surviving below the poverty line. Other alarming data regard the maternal and infant mortality rate, as well as a too low literacy rate. This explains why, in the last decades, Indian CSR has moved from a philanthropic form of business donations and contributions to a more structured practice addressing the urgent developmental challenges of the country (Balasubramanian *et al*., 2005).

Although this law is completely legitimate and justifiable for what concerns its final purpose, it's still not clear whether this imposition represents a benefit or a loss for the targeted companies. Existing empirical evidence on whether CSR investments create shareholder value is inconclusive, partly because many studies related to different countries CSR are clouded by methodological concerns such as potential endogeneity, reverse causality, or omitted variable problems (Margolis *et al*., 2009). Before the introduction of Section 135 CA, in fact, the choice to conduct CSR activities had always been fully voluntary. Thus, reverse causality could drive the research results: as highlighted by Hong, Kubik, and Scheinkman (2012), firms that are doing well, and are hence less financially constrained, are more likely to spend resources on CSR activities. Hence, firm performance could cause higher future CSR, as opposed to the other way around.

To partially overcome the inferential problems of previous studies, H. Manchiraju and S. Rajgopal (2017) applied their research to the unique regulatory framework of the Indian Companies Act 2013 to test whether the mandated CSR expenditure had affected Indian firms'

shareholder value in a positive or negative way. This allowed them to exploit numerical thresholds specified in the mandatory CSR rule by employing a Regression Discontinuity Design (RDD). The discontinuous threshold is represented by the profit threshold of INR 50 million, exogenously determined by the CA. Such discontinuity classifies firms as *AFFECTED* those who report a profit just above INR 50 million and are required to comply with CSR rule; conversely, *UNAFFECTED* firms are those who are not required to comply with CSR rule having a profit just below the threshold. Intuitively, there is no reason to expect systematic differences in a firm with a net income of INR 51 million and another with a net income of INR 49 million. Accordingly, any difference in firm value, measured around eight important event dates underlying the legislative passage of the mandatory CSR rule, between affected and unaffected firms could be reasonably attributed to the CSR rule.

Ex ante, it is difficult to predict the impact of the mandatory CSR rule on shareholder value. In situations where firms' CSR activities are not aligned with their shareholder's interests, the new mandatory CSR rule will likely force firms to redirect their CSR spending to maximize firm value, leading thus to an increase in the shareholder value of firms affected by the rule (Cheng *et al*., 2013). However, if firms already conduct CSR to maximize their firm value before the law was passed, imposing binding legal constraints on their CSR choices will lead to declines in their shareholder values (Demsetz and Lehn, 1985).

To capture the effect of the CSR rule on firm value, Manchiraju and Rajgopal compare the Cumulative Abnormal Returns of *Affected* and *Unaffected* firms around the eight event dates that represent major milestones in the legislative passage of the Act; the return on CNX 500 index is used as a proxy for market return. The main explaining variable is a dummy capturing the overall differential market reaction for the *Affected* firms relative to *Unaffected* firms on a certain event date. The regression model includes several control variables: other than firm size, book-to-market ratio and leverage, commonly employed in other studies related to the CSR matter, two variables related to the audit quality and board independence are included. Moreover, an element of originality is represented by a dummy variable indicating whether a firm belongs to a *heavily polluting industry* or not, considering the industries identified as such by the Ministry of Environment and Forests.

The study found that, on average, firms that were forced to spend money on CSR experienced a 4.1% drop in the stock price around the eight events. In particular, given that firms are required to spend 2% of their profits on CSR, the passage of this rule is resulting in a 2% decline in shareholder value, corresponding directly to cash outflows of CSR activities, to the extent CSR-related activities are negative NPV projects.

Manchiraju and Rajgopal's study results suggest that, on average, the mandatory CSR rule has imposed significant net costs on affected firms' shareholders. Furthermore, these results can be attributed the interpretation that giving the firm flexibility to define what CSR means and letting it choose where it wants to direct its CSR spending is preferable from the shareholder's perspective. Their findings also indicate that firms, left to their own devices, choose their optimal level of CSR spending designed to maximize their firm value.

1.4 Mandatory CSR Assurance Practices in South Africa.

King III introduced in 2009 the South African Assurance Practices with the King Code of Governance for South Africa. One of the Code's principles requires adopting organisations to provide independent assurance on their CSR disclosures. This law, more than the Indian one, constitutes an example of integration between mandatory and voluntary CSR dimensions: King III originally introduced the entire governance code in a voluntary adoption sense. The Johannesburg stock exchange (JSE) regulations, right after, required all JSE-listed companies to apply the King III principles. It has accordingly become a *de facto* mandatory requirement for all JSE-listed companies, albeit on an "apply or explain" basis. Such regulatory requirement has made South Africa one of the first countries that require certain companies to not only disclose their CSR-related performance, but also to provide independent assurance thereon (Ackers and Eccles, 2015).

The institutionalisation of CSR assurance practices in South Africa was driven by the previous inconsistent application of voluntary CSR assurance practices, with the consequence of impairing the ability of stakeholders to understand the nature and scope of CSR assurance engagements. King III has introduced a principle-based voluntary code of conduct, advocating an "apply or explain" approach, with the aim of acknowledging and pointing out to African companies that "planet, people and profit are inextricably intertwined" (IoD, 2009).

Stakeholders' trust in corporate disclosures, and therefore in the company itself, is enhanced when companies issue transparent CSR reports and provide users with relevant, accurate, reliable and credible information (Marx and van Dyk, 2011). In general, a decade ago non-financial information was still perceived as less credible than statutory financial information, as the former was usually subject to independent verification, whereas the latter is usually not (Gouws and Cronjé, 2008). Thereby, it's not surprising that, without appropriate legislation and regulations regarding CSR reporting, many South African organisations were voluntarily adopting the principles of the various iterations of the King Code of Governance to improve their governance practices and demonstrate their increased accountability (Marx and van Dyk, 2011). This behaviour can be considered as an attempt to compensate for the lack of universally

agreed standards and frameworks, which represent the premise for CSR disclosure all around the world.

Similarly to the other typologies of CSR mandates, the success and appropriateness of King III and JSE principle on assurance practices is not that obvious but, on the contrary, it may be argued that successful voluntary governance initiatives are not based on an enforcement regime, but rather on embedding self-regulation in the corporate fabric. In 2015 Ackers and Eccles carried out a longitudinal study to test the effectiveness of the mandate introduced by the Johannesburg stock exchange on King III's principle application. The study examined the CSR assurance reports for 2007/2008 (before King III) and 2010/2011 (after King III) published by JSE-listed companies. In order to understand the impact of King III on South African CSR assurance practices, the CSR assurance reports for 2011/2012 were examined. The empirical component of this exploratory study was conducted in two phases. The first phase examined the annual/CSR reports of the selected companies to establish the *extent* of CSR assurance provided. In order to identify the CSR *assurance providers* and to understand emerging assurance practices with their implications, the second phase involved a content analysis of the identified CSR assurance reports (Babbie and Mouton, 2011).

A consistent growth in CSR assurance emerged across the study period, clearly illustrating the greater impact of King III on larger companies affected by the mandate. Moreover, the study revealed that larger companies were already providing independent assurance on their CSR disclosures prior to King III, illustrating that larger companies are more likely to have their CSR disclosures independently assured than smaller companies. On the other hand, despite the "apply or explain" requirement of King III, in the annual/CSR reports several companies did not disclose reasons for not providing independently assurance of their CSR disclosures.

Another important result of this study was that, despite the remarkable increase in the level of assurance on African companies' CSR reports, the layout and structure of the reports for CSR assurance engagements reflect significant variation. There are even differences in the assurance reports issued by the same assurance provider. The lack of a clearly defined and standardised approach for CSR assurance therefore compromises the ability of CSR and CSR assurance report users to establish exactly what has been assured, and the extent of confidence that may be placed on the underlying CSR disclosures.

1.5 Indonesian 2007 Corporate Law N. 40: Application Problems.

The 2007 Indonesian Law No. 40, together with 2007 Indonesian Investment Law No. 25, is an interesting case of CSR regulatory framework that has created significant debate over the voluntary vs. mandatory nature of these two Corporate Social Responsibility (CSR) disclosure

initiatives. The contradictions between the two laws generated a significant legal uncertainty among Indonesian corporations. Under Article 15 of the 2007 Investment Law No.25, every corporation is obliged to implement corporate social and environmental responsibility.

In contrast, Article 74 of the 2007 Limited Liability Corporation Law No. 40 only requires companies conducting their business activities in and correlated to the field of natural resources to make CSR investments, elucidated as ‘‘the obligation of the company which is budgeted and calculated as the cost of the Company.’’ In other words, the obligation for the company consists in spending a mandatory amount for implementing CSR which can be accounted for as a corporate cost. Sanctions can be imposed for failure to comply with such an obligation differently from the 2007 Investment Law No.25, which does not impose any sanction. A further difference from Investment Law No. 25 is that the adoption of Article 74 of the 2007 Corporate Law No. 40 has provoked strong reactions especially due to the presence of two opposing groups of actors with contrasting interests. While civil society is primarily concerned with the implementation of such regulation, the business community (shareholders, investors, analysts, etc,) is more concerned with their impact on corporate costs and their competitive disadvantages.

The Indonesian Chamber of Commerce (KADIN) and several corporations, representing the business interests, even questioned the constitutionality of Law No. 40 before the Constitutional Court. Their arguments were that Article 74 creates legal uncertainty as it is not in accordance with the CSR movement’s voluntary emphasis; it is unjust and discriminatory, particularly toward certain corporations to whom it’s imposing an additional burden, and for this reason will negatively impact the economic situation, in general. The Court, instead, ruled in April 2009 that Article 74 is correct, non-discriminatory and just, holding that CSR is a flexible concept which is subject to the interpretation of each country. The Judges also argued that Article 74 does not discriminate against particular corporations, as it is based on the potential risks posed by corporate behaviour to natural resources. Thus, according to them, it is logical for those parties impacting natural resources to be the ones to bear the burden.

Explicit CSR policies relying on voluntary corporate engagement or acknowledgment in Indonesia was still in its early stages when the CSR Law entered into force (Uriarte, 2008). Primarily only multinational or large corporations had promoted the adoption of CSR policies, which mostly derived from their headquarters or pressure from various elements of society, whereas for the small or medium corporations CSR was implemented in only a very limited sense or still perceived as a ‘‘foreign’’ concept. The sluggish reception of this type of CSR in Indonesia is very much the function of two major issues: 1) the lack of knowledge regarding CSR, often perceived as a western concept associated with philanthropic acts, cause-related

marketing, or public relations; 2) the general misperception that CSR represents a net cost, as opposed to an investment. What's more, poor legal enforcement, corruption, and excessive overlap among different laws have been problems common to all sectors, giving as a result legal uncertainties regarding substance, additional administrative costs, and bureaucracy. Hence, there is a real need for continuous efforts to educate and train business leaders, employees and other stakeholders, including government and NGOs, to make larger commitments (Waagstein, 2010).

The mandatory nature of Law No. 40 is one way of ensuring that there is no free ride for corporations (Priyono, 2007). Moreover, mandatory CSR can be a complement, not a replacement, to other remedial mechanisms. The Indonesian case is once more supporting the theory according to which, although CSR was originally intended to be voluntary, it develops in a particular country depending on the special characteristics of that country, thus admitting the possibility of imposing mandatory responsibility.

1.6 Mandatory CSR Disclosure in China.

The Chinese regulation enacted in 2008 ties up the mandatory CSR disclosure subject, discussed so much in recent years. Ioannou and Serafeim (2017), in their previously cited article, reported positive results after questioning whether mandatory sustainability reporting regulations increase firms' CSR disclosure. Chen, Hung and Wang (2018), in turn, assess the impact of the CSR mandate on social externalities, specifically focusing on environmental pollution. Although this mandate did not require any changes in firm behavior, they posit that mandatory disclosure impacts a firm's activities because the increased transparency can make it easier for governments and interest groups to pressure firms to engage in more CSR activities. The mandatory disclosure was introduced in December 2008 by both the SSE (Shanghai Stock Exchange) and the SZSE (Shenzhen Stock Exchange) for a subset of firms listed on their respective exchanges, to ensure transparency of firms about their CSR. Therefore, the study sample was drawn from firms listed on the key stock exchange indices, hence very large firms.

The general environmental pollution is represented by the sum of two variables: industrial wastewater discharge, measuring water pollution, and SO2 emission that measures air pollution. The explaining variable of interest in the regression model is the interaction term between a dummy variable indicating whether the period is post-period and another dummy variable indicating whether the city is "most impacted" by the disclosure mandate. What emerges is that the most impacted cities experience a greater decrease in industrial wastewater and SO2 emission subsequent to the mandate.

In opposition to the positive results above, the same research further reveals a definitely lower advantage for shareholders from the imposition of CSR disclosure. Chen, Hung and Wang (2018) investigated the effects of the CSR mandate in terms of improvement or deterioration of firm profitability, measured by return on assets (ROA) and return on equity (ROE). The assumption is that, as firms would have undertaken such activity before the mandate if it were beneficial to performance, this increase in CSR activity had come at a cost to performance. A DiD research design was employed in order to compare changes in firm profitability among treatment firms with changes in firm profitability among benchmark firms during the period 2006-2011. Using ROA allows to make inferences regarding firm performance independent of leverage, while using ROE allows to make more comparable inferences regarding shareholder wealth. ROA and ROE are regressed on a dummy variable indicating whether the period is post-period, a dummy variable indicating whether the firm is a mandatory CSR reporting firm, and their interaction term.

This second regression results are not as optimistic as for the previous ones concerning the mandate effects on the environment: the negative coefficient on the interaction term is suggesting that firms subject to mandatory CSR reporting experience a decrease in profitability subsequent to the disclosure shock. This change is also economically significant, with *ROA* and *ROE* decreasing by 26% and 20% respectively. Chen, Hung and Wang interpreted these results as evidence that firms respond to the mandate by shutting down some production facilities and increasing their spending on pollution control and the labor force, as reflected in the higher operating costs.

In sum, their findings are consistent with the notion that mandatory CSR disclosure changes firm behavior and generates positive externalities to society at the expense of shareholders.

The Chinese context was also exploited by Wang, Cao and Ye (2018) as a quasi-natural experiment, in order to study the CSR reporting mandate from a completely different perspective: they assessed the impact of mandatory CSR reporting on financial reporting quality, in particular questioning whether firms subject to the regulatory CSR disclosure are less likely to engage in earnings management. Investigating the impact of CSR disclosure on earnings management improves the general understanding about the role of CSR disclosure on capital markets. Indeed, managers with different motives for financial reporting may disclose CSR information strategically. For instance, managers may use voluntary CSR reporting either to signal the reliability and veracity of their financial information, leading to a negative relation between CSR and earnings management, or to camouflage their earnings-management

activities, resulting in a seemingly positive association between CSR and earnings management (Hemingway and Maclagan, 2004).

The analysis was performed over a sample of 1888 firms listed on China's stock exchanges between 2003 and 2012, given the 2008 mandate for a subset of Chinese listed firms to issue CSR reports along with their annual reports. The findings illustrate that the absolute discretionary accruals of the mandatory CSR reporting firms are significantly lower than those of the non-CSR reporting firms after the disclosure regulation. Such an improvement in the financial reporting quality is due to a reduction of the information asymmetry between firm managers and the public. CSR reporting, in fact, tends to increase the firms' exposure to public attention: when more investor and media attentions are drawn toward the firm, any misbehavior of the managers is more likely to be detected and punished. Consistent with the arguments, the study found that the mandatory disclosure effect was more pronounced among firms with worse information environments, that's to say firms with lower analyst coverage.

Further analyses revealed that upward earnings management by mandatory CSR firms is more likely to be caught after the policy. These results together confirm that mandatory CSR reporting reduces information asymmetry between managers and investors (regulators), increases the probability of detection, and therefore deters firms' earnings management activities.

1.7 Directive 2014/95/EU and the European Context.

In 2014, the European Union (EU) passed a corporate social responsibility (CSR) directive that mandates large firms listed on EU stock exchanges to prepare comprehensive non-financial reports on CSR. This directive lays down the rules on disclosure of non-financial and diversity information by large public-interest companies with more than 500 employees. This companies target covers approximately 6,000 large companies and groups across the EU, including listed companies, banks, insurance companies and other companies designated by national authorities as public-interest entities.

Starting from the last fiscal year 2018 onwards, companies considered large, according to their number of employees, have to publish reports on the CSR policies they implement as part of their annual reports. The European Parliament and Council have broadly indicated in the Directive 2014/95/EU that, from a quantitative point of view, the reported information must be "to the extent necessary for an understanding of the group's development, performance, position and impact of its activity". But, at the same time, they have fixed a *minimum content* for the companies' non-financial reports, represented by the areas of main concern, that's to say "environmental, social and employee matters, respect for human rights, anti-corruption and

bribery matters". The EC also specifies that such statement should include a description of the policies, outcomes and risks related to those matters and should be included in the management report of the undertaking concerned.

One of the major objectives of this directive is to ensure a certain level of uniformity and comparability of CSR disclosures among the largest companies all around Europe, together with emphasizing the relevance of CSR activities for the businesses belonging to every industry. A EU Directive as such has also the peculiarity of not imposing its content directly to the targeted companies; it instead lets each single Member State enforce those rules in the way deemed the most appropriate to the country's legal, social and institutional framework.

Indeed, the EU only specified in the directive text that by December 2016 the Member States would have to "bring into force the laws, regulations and administrative provisions necessary to comply with this Directive". A great level of flexibility is also left to EU companies for what regards the way of reporting information on their policies, main risks, and outcomes related to environmental and social matters. In June 2017 the European Commission published its guidelines to help companies disclose environmental and social information, but they are not mandatory and companies may decide to use international, European or national guidelines according to their own characteristics or business environment.

Although this directive is a legal requirement, there is no sanction for non-compliance and CSR reports will be audited but not verified. For this reason, it has been included in the "soft–hard law category", representing those mandatory standards (hard law) characterized by a low level of formalization and weak sanctions (Gatti *et al*., 2018).

The 2014 Directive is situated in a European context where CSR had already started playing an important role at the end of the 19th century. The European Union, in fact, has been the continent that first became a convert to the CSR movement (Mullerat, 2013), where this movement is identifying the last two decades growing trend involving the more advanced economies which have increased their efforts to promote responsible business practices. Among the main reasons for the EU primacy, the presence of more CSR consistent values, norms and perceptions than in other areas of the world, jointly with European corporations' tendency to hold stronger and broader approaches to stakeholder relations. In 2000, during the Lisbon Summit, the EU heads of state openly made the commitment to: "make Europe the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion by 2010".

However, before 2011, the EC wanted CSR in Europe to remain a voluntary initiative for European business to practice. This idea appears evident in the EC's earlier definition, adopted in 2001, that called for companies to integrate "social and environmental concerns in their

business operations and in their interactions with their stakeholders on a voluntary basis." While the EC had taken a position of rejecting regulation and putting the emphasis on voluntary measures for business, the European Parliament, together with NGOs and trade unions, had been demanding mandatory regulation and reporting of corporations' social and environmental impacts and transparency. Indeed, in 2002 the European Parliament was already voting for a new legislation to require companies to publicly report annually on their social and environmental performance, to make board members personally responsible for these practices and to establish legal jurisdiction against European companies' abuses in developing countries. The European Corporate Social Responsibility scenario changed when, in 2011, the EC published a renewed EU strategy 2011-14 for CSR to support entrepreneurship and responsible business. The new policy stated that, to meet their social responsibility, enterprises "should have in place a process to integrate social, environmental, and ethical and human rights concerns into their business operations and core strategy in close collaboration with their stakeholders". The 2011 policy enhanced the visibility of CSR and the relevance of good sustainability practices to spread over all the EU companies. Moreover, it confirmed the EC's intention to bring forward a new legislative proposal on this issue. The first European legislative measure regarding CSR would later be enforced for the first time in 2014, amending the Directive 2013/34/EU, entitled "Single Market Act": this previous directive aimed at ensuring the clarity and comparability of financial statements, other than international financial reporting standards (IFRS), limiting administrative burdens and providing for simple and robust accounting rules, especially for small and medium-sized enterprises (SMEs). It was only with the European Directive 95, however, that non-financial information began to play a non-marginal role in the annual reports of, at least, larger European companies.

It's totally plausible that European companies affected by the CSR regulation have been compliant from the very first year of application, possibly increasing their CSR disclosure as Ioannou and Serafeim (2017) empirically proved in a similar scenario where an Environmental, Social and Governance (ESG) disclosure regulation had been imposed to a certain subgroup of firms.

In a similar way, Wang et al. (2018), regarding the Chinese Context, have highlighted that the increase of reported non-financial information, in turn, raised firms' exposure to public attention, therefore producing a reduction of information asymmetry between firms' managers and the public. Empirical evidence regarding the Chinese CSR disclosure regulatory framework also shows that, through mechanisms that involve certain firm's stakeholders, the obligation to report a firm CSR performance can positively impact a firm's own CSR performance. In

particular, Chen, Hung and Wang (2018) have statistically proved that the Chinese 2008 CSR disclosure mandate had positive diminishing effects on the environmental pollution. Their deduction is that, although such a mandate does not require any changes in firm behavior, a mandatory disclosure impacts a firm's activities because the increased transparency can make it easier for governments and interest groups to pressure firms to engage in more CSR activities. Nevertheless, the literature investigating the relation between mandatory CSR disclosure and firm CSR performance is not wide enough to confidently confirm the positive effect found out with respect to the Chinese regulatory framework, especially considering that the 2018 study (Chen *et al.*) only focused on environmental performance. Up to now, different types of CSR regulations have been mostly investigated from a shareholders' perspective, with results that in most of the cases claim a consequential loss in shareholder value, for example in terms of a stock price drop (Manchiraju and Rajgopal, 2017) or measured by a reduction in firm ROA and ROE (Chen *et al*., 2018). However, when dealing with the implementation of CSR activities, the firm profitability cannot be the main focus: as Freeman affirms (2004), firms should go beyond merely maximizing stockholder value to address the corporate sustainability objective in which other stakeholders are interested.

This study research question raised to find an answer on whether the European Directive 95 is achieving, other than the EU companies' transparency, also the objective of CSR performance enhancement. Such findings are mostly relevant for countries policy makers in order to take reasonable decisions on the imposition of CSR disclosure to national companies, after an extensive analysis of different types of consequences, not only from an economic standpoint.

Summarizing all the findings and assumptions discussed above, I can formulate the following Research Question:

RQ1: Did Directive 2014/95/EU positively affect targeted firms' CSR performance?

2. European CSR Disclosure Regulation and CSR Performance

2.1 Sample, data sources and Regression Model.

The introduction and the even more recent application of such EU Directive has represented a great change in the CSR practices of large European companies. As shown in different articles reported in the previous chapter of this work, the introduction of mandatory CSR disclosure can potentially bring a great variety of consequences. I will exploit the European regulatory change to investigate one specific effect of the 2014 Directive which, according to my research, has not been explored yet. The research question of my study is whether the firms obliged by law to report on their CSR activities have increased their CSR performance. At the moment, the

CSR reporting mandate has affected the targeted subgroup of European companies only in fiscal year 2018. Therefore, my research covers only one year of Directive application (2018) and the two years before (2016-2017), in order to test whether the mandate has determined a significant change in the CSR reported by firms. In the firms sample I solely included companies listed in a EU stock exchange and exceeding the objective threshold of 500 employees, which determines the applicability of the Directive 2014/95/EU. I selected all firms belonging to the S&P Europe 350 Index: it is composed by 350 leading blue-chip companies drawn from 16 developed European markets that, if only for their size and their financial soundness, can be considered public-interest entities. During the extraction of all the needed data from Thomson Reuters Eikon database, I made a further skimming on the basis of data availability, ending up with a sample made of 317 companies, differentiated by 18 industries. Table 1. below reports the *Stata* Frequency Table of the different industries (*ind1*) in which the sample has been categorized. The column *Freq.* shows the number of observations falling in each industry category, while the column *Percent* shows the frequency of each industry in percentage terms.

Table 1. *Industries frequency for the total 951 observations, obtained from the sample's 317 companies multiplied by 3 years of analysis (2016-2018).*

ind1	Freq.	Percent	Cum.
AUTOMOBILES AND AUTO PARTS	36	3.79	3.79
BASIC MATERIALS	18	1.89	5.68
CHEMICALS	54	5.68	11.36
CYCLICAL CONSUMER PRODUCTS	54	5.68	17.03
CYCLICAL CONSUMER SERVICES	39	4.10	21.14
ENERGY	36	3.79	24.92
FINANCIAL	198	20.82	45.74
FOOD & BEVERAGES	51	5.36	51.10
HEALTHCARE	24	2.52	53.63
INDUSTRIALS	162	17.03	70.66
MINERAL RESOURCES	27	2.84	73.50
PERSONAL & HOUSEHOLD PRODUCTS & SERVICE	9	0.95	74.45
PHARMACEUTICALS	33	3.47	77.92
RETAILERS	42	4.42	82.33
TECHNOLOGY	45	4.73	87.07
TELECOMMUNICATIONS	42	4.42	91.48
TRANSPORTATION	30	3.15	94.64
UTILITIES	51	5.36	100.00
Total	951	100.00	

As mentioned before, the final objective of the Directive is to increase European companies' transparency and performance on environmental and social matters, thus effectively contributing to long-term economic growth and employment. To answer the research question about the regulation effect on firm Environmental, Social and Governance (ESG) performance, I have built an Ordinary Least Squares (OLS) regression model, whose dependent variable needs to be a measure of European companies ESG performance. For this purpose I have selected some Thomson Reuters Eikon ESG Scores, which were employed in other reliable

studies as a measure of companies' Environmental, Social and Governance Performance (i.e. Garcia *et al*., 2017; Duque-Grisales and Aguilera-Caracuel, 2019).

Eikon ESG Scores measure a company's relative ESG performance, commitment and effectiveness across 10 main themes (emissions, environmental product innovation, human rights, shareholders, etc.) based on company-reported data (*Thomson Reuters ESG scores*, 2018). Their characteristic of being based on information reported by the companies themselves, however, represents a limitation of these ESG scores which may even lead someone to contest their appropriateness for measuring firm ESG performance. Nevertheless, the reason why other reliable studies have used them, as aforementioned, is the lack of multiple alternative measures of ESG performance. Moreover, they can be considered a robust, data driven assessment of companies' ESG performance and capacity where company size and transparency biases are minimal, thanks to one of the largest ESG content collection operations in the world (Thomson Reuters EIKON, 2018).

The first regression dependent variable is the *ESG Combined Score,* which represents a comprehensive scoring of a company's ESG performance based on the reported information in the ESG pillars, with ESG controversies overlay captured from global media sources. *Appendix 1* reports 10 categories in which the ESG pillars are divided and the specific weight attributed to each category in order to get company's ESG Combined Score.

In the regression model the explaining variable of main interest consists in the dummy variable *eudir*, assuming value equal to 1 if the targeted companies were subject to the application of the CSR disclosure mandate in a certain fiscal year, equal to 0 if not. This variable is built to capture whether the beginning of the Directive application has determined a significant change in the ESG performance of the sample firms.

In addition, a number of control variables has been included in the regression, for limiting problems related to endogeneity and omitted variables. I have chosen these variables on the basis of previous studies related to similar CSR research questions, exclusively classified as high-ranking articles either on the *Budget Integrato Ricerca Dipartimentale (BIRD) 2018*, by the Dipartimento di Scienze Economiche e Aziendali "Marco Fanno", or on the *Academic Journal Guide 2018*, by Chartered Association of Business Schools.

Table 2 summarizes all the explaining and control variables; each of them is later described in an extended form.

Table 2. *Regression independent variables.*

Variable	Measure
Dummy for Directive 2014/95/EU application	eudir: assumes value of 1 for years in which a company is subject to the application Directive 2014/95/EU (2018), value of 0 for years before 2018 when the Directive was not to be applied yet.
Audit Committee Independence (Thomson Reuters)	audit: continuous variable assuming values between 0 and 100. Estimated during each fiscal year by Thomson Reuters on the basis of the independence of audit committee members, the responsibility of the audit committee to select and oversee an issuer's independent accountant and the ability of the audit committee to retain outside advisers.
Return on Assets (Thomson Reuters)	roa: profitability ratio, calculated for each fiscal year as end-year income divided by the mean of total assets in past 12 months. It's used as an indicator to show how well a company utilizes its assets to generate a return.
Market Capitalization/ Common Equity (Thomson Reuters)	mcap_eq: Market to Book Ratio, in which the numerator is calculated as a company's total of number of shares multiplied by their fiscal year close price; the denominator is calculated as the company's number of common shares multiplied by their book value.
Natural logarithm of Market Capitalization (Market Capitalization from Thomson Reuters)	ln_mcap: firm size indicator, calculated as the natural log of the market value of equity, which us a company's stock price at the end of fiscal year∗number of shares outstanding
Total Debt/ Total Assets (Thomson Reuters)	tdebt_tass: leverage ratio, measuring the amount of total assets that are financed by creditors instead of investors.
Cash & Cash Equivalents/Total Current Assets (Thomson Reuters)	cash_ratio: liquidity ratio, calculated as cash and marketable securities at the end of year/total current assets at the end of year, where the numerator includes

	instruments that can be converted into cash in three months or less.
Capital Expenditure/Total Assets (Thomson Reuters)	capex_tass: a measure of firm capital immobilized in a financial year for a medium/long term gain. Calculated as capital expenditure during the year/total assets at the end of year.
Dummy indicating Highly Polluting Industries	hpoll_ind: assumes value of 1 if a firm belongs to one heavily polluting industries, as defined by Eurostat; 0 if not.

The variable *audit* is the Eikon score *Audit Committee Independence*, which measures the quality of the internal auditing on firms' non-financial reports. I have chosen Return on Assets (*ROA*) as a firm profitability ratio because firms with better financial performance likely have more resources to practice CSR activities and produce better CSR reports. The Market Capitalization to Common Equity ratio (*mcap_eq*) is comparing the value attributed to a firm by the market with the book value of its equity. In general, a higher Market to Book ratio is considered to be less risky because the firm has less debt, or leverage, and the opposite holds true (Manchiraju et al., 2017). The natural logarithm of Market Capitalization (*ln_mcap*) is a control for firm size, because size captures various factors motivating firms to issue CSR reports such as public pressure or financial resources. I also included in the model a control variable for firm leverage, calculated as total debt over total assets, because debt servicing plays a monitoring role and debt holders demand greater disclosure (Dhaliwal *et al.*, 2011). I have taken a leaf out of the 2017 empirical study by Manchiraju and Rajgopal to include two more financial ratios as control variables: a cash ratio, calculated as Cash & Cash Equivalents/Total Current Assets, and a capex ratio, calculated as Capital Expenditure/Total Assets. The cash holdings and the capital expenditures of a firm are likely not to change much in the years of observation 2016-2018 and, in the meanwhile, are likely to affect a firm CSR performance through their influence on firm ability to make investments on CSR activities and the related disclosure. The last control variable of my model, *hpoll_ind*, consists in a dummy variable capturing whether a firm belongs to one of the heavily polluting industries defined by Eurostat in its 2010 report entitled "Environmental Pressure of Sectors, by NACE code". The industries defined as such consist in the twenty sectors with the greatest aggregated impact per unit of Gross Value Added. I have included this variable on the heels of other studies examined in the previous chapter, with the expectation that highly polluting firms in general tend to invest more in CSR in order to improve the corporate image and reputation in the eyes of their stakeholders.

The first OLS regression model specification, altogether, is as follows:

$$ESG\_comb_i = \beta_1\, eudir_i + \beta_2\, audit_i + \beta_3\, ROA_i + \beta_4\, mcap\_eq_i + \beta_5\, ln\_mcap_i + \beta_6\, tdebt\_tass_i + \beta_7\, capex\_tass_i + \beta_8\, cash\_ratio_i + \beta_9\, hpoll\_ind_i$$

Appendix 2 reports the correlation matrix referring to all the explaining and control variables.
Notwithstanding the validity and the meaningfulness of the *ESG Combined Score*, I wanted to deepen the analysis of the European CSR Directive effects over the CSR performance of European companies. Although a combined score can give a general idea about this change, it doesn't represent in-depth the Directive's impact on each ESG pillar. Therefore, I used all the previously described independent variables to be regressed on eight more dependent variables, which consist in some of the *ESG Combined Score* components. I have selected them from various variables composing each ESG pillar on EIKON database, according to their relevance in the ESG Combined Score and also based on whether they were present for the companies sample in the three years of study. *Appendix 3* provides an explanation of the 8 ESG Scores taken into consideration.

2.2 Results and Model Limitations.

Prior to the final regressions on Stata, I performed an independent t-test for each dependent variable, in order to determine whether they present a statistically significant difference before and after Directive 2014/95/EU application.
Table 3 below shows the test results related to the *ESG Combined Score* dependent variable.
A p-value much lower than 0.05 is rejecting the null hypothesis, thus proving that the difference between the variable mean values in the first two years and in the last year of observation is significant. In other words, the t-test is demonstrating that in years 2016-2017 the ESG combined score of the observed companies was, on average, 5.56% higher than in fiscal year 2018. This output is coherent with and is anticipating the regression results, which will follow in this paragraph.

Table 3. *T-test performed on the dependent variable ESG Combined Score.*

Group	Obs	Mean	Std. Err.	Std. Dev.	[95% Conf.	Interval]
Placebo	634	56.73904	.6815094	17.15997	55.40075	58.07733
Treated	317	53.7503	.8856619	15.76876	52.00776	55.49284
combined	951	55.74279	.543486	16.76018	54.67622	56.80936
diff		2.988738	1.149428		.7330237	5.244453

diff = mean(Placebo) - mean(Treated) t = 2.6002
Ho: diff = 0 degrees of freedom = 949

Ha: diff < 0 Ha: diff != 0 Ha: diff > 0
Pr(T < t) = 0.9953 Pr(|T| > |t|) = 0.0095 Pr(T > t) = 0.0047

Among the other dependent variables taken into consideration, only three of them have shown a significant mean-difference in their respective t-tests; in particular, two are related to the Environmental pillar (*Emission Reduction/Innovative Production Score* and *Emission Reduction/CO2 Reduction Score*) and one to the Social pillar (*Employment Quality/Employment Awards Score*). For all these three variables, the mean value after the EU Directive application is lower than before, which reflects the average change in the overall *ESG Combined Score*. Moreover, a significant mean-variation in only these two pillars is coherent with the composition of the ESG Combined Score, in which they play the major role.

The statistical regression results are in contrast with the positive expectations generated by going through previous literature regarding CSR disclosure imposed in other countries.
As stated before, I used an OLS linear model to verify the Hypothesis 1.
Table 4 below shows the *Stata* results obtained by regressing the dependent variable ESG Combined Score on the independent variable of interest, *eudir*, and all the control variables.

Table 4. *Stata output: regression of ESG Combined Score on all the explaining variables, years 2016-2018.*

esg_comb	Coef.	Robust Std. Err.	t	P>|t|	[95% Conf.	Interval]
eudir	-3.23412	.6493255	-4.98	0.000	-4.511668	-1.956572
audit	.0662662	.0311557	2.13	0.034	.0049675	.127565
roa	.1446522	.1080797	1.34	0.182	-.0679946	.3572989
mcap_eq	.0013638	.004082	0.33	0.739	-.0066676	.0093952
ln_mcap	-2.635345	.5506429	-4.79	0.000	-3.718735	-1.551956
tdebt_tass	-.0549382	.0442831	-1.24	0.216	-.1420652	.0321888
capex_tass	.3635809	.2240298	1.62	0.106	-.0771976	.8043593
cash_ratio	-.1421233	.048966	-2.90	0.004	-.2384639	-.0457827
hpoll_ind	.4154205	1.507991	0.28	0.783	-2.551551	3.382391
_cons	98.35689	10.05256	9.78	0.000	78.57848	118.1353

A negative and statistically significant *eudir* coefficient is signalling that when the sampled companies started reporting their ESG performance because of Directive 2014/95/EU imposition, they showed a worse performance, at least in some ESG areas subject of regulation. Subsequently, I excluded from the regression model the less significant explaining variables, which I identified according to two criteria: their t-test reported in Table 3 and by separately regressing the dependent variable on each single independent and control variable. Based on these parameters, I excluded the variables *ROA*, *Market Cap/Common Equity*, *Total Debt/Total Assets* and the dummy variable *Heavily Polluting Industry*. However, the results did not change much, in terms of both *R-squared* and significance of the explaining variables.

Afterwards, I made a different adjustment to the regression by eliminating one year of observation: 2017. This can be presumably considered as a year of transition, where the targeted European companies were already getting prepared to the application of the CSR disclosure mandate. The following Table 5 shows whether this assumption makes sense.

Table 5. *Stata output: regression of the dependent variable ESG Combined Score, years 2016 and 2018, excluding 2017.*

esg_comb	Coef.	Robust Std. Err.	t	P>|t|	[95% Conf.	Interval]
eudir	-4.381319	.8136761	-5.38	0.000	-5.982226	-2.780412
audit	.0788787	.0325911	2.42	0.016	.0147556	.1430018
roa	.3315187	.0953277	3.48	0.001	.1439615	.519076
mcap_eq	.0055321	.1330757	0.04	0.967	-.2562942	.2673584
ln_mcap	-3.020837	.5723165	-5.28	0.000	-4.14687	-1.894805
tdebt_tass	-.0244523	.0449649	-0.54	0.587	-.1129207	.064016
capex_tass	.227787	.2247242	1.01	0.312	-.2143577	.6699317
cash_ratio	-.1400586	.0499911	-2.80	0.005	-.2384161	-.041701
hpoll_ind	-.1287356	1.609214	-0.08	0.936	-3.294864	3.037392
_cons	103.6406	10.53729	9.84	0.000	82.90854	124.3727

We can immediately observe an even more negative effect of the Directive application on the ESG Combined Score, given an increase in the R^2 of the total model by nearly 0.03 and a clear modification in the significance of the explaining variables. This is consistent with the hypothesis that 2017 is a passage year, therefore the Directive effect on companies' CSR performance will appear smoothed if we include its related observations in the regression. However, this "more negative" relationship between the application of the CSR disclosure directive and firms' CSR performance disagrees with our expectations even more than in Table 3 model.

Among the regressions performed for the other dependent variables taken into consideration, I will only report the results of those showing a statistically significant correlation with the

dummy variable *eudir*. Not surprisingly, three of these variables correspond to those presenting, in the T-tests reported above, a mean value significantly different before and after the CSR mandate application. Only the variable *Emission Reduction/Policy score* showed a positive correlation with my independent variable of interest, though its change following the directive application was not very significant. In the following Tables 5 to 8 I have reported the Stata results of these variables, related to only two of the ESG pillars, that is to say social and environmental.

Table 6 presents the Stata output of regressing *Emission Reduction/Policy score* on all the nine explaining variables already illustrated above. This EIKON Score, belonging to the environmental pillar, is a measure of whether and how a company is implementing a policy for reducing environmental emissions or its impacts on biodiversity.

Table 6. *Stata output: regression of the dependent variable emission_policy, years of observation 2016-2018.*

emission_p~y	Coef.	Robust Std. Err.	t	P>|t|	[95% Conf.	Interval]
eudir	1.133449	.1469895	7.71	0.000	.8442473	1.422651
audit	.0904003	.058803	1.54	0.125	-.0252947	.2060952
roa	-.0485461	.0939024	-0.52	0.606	-.233299	.1362069
mcap_eq	-.0177557	.015178	-1.17	0.243	-.0476184	.012107
ln_mcap	3.679312	1.047337	3.51	0.001	1.618677	5.739947
tdebt_tass	-.0559684	.0805642	-0.69	0.488	-.2144783	.1025416
capex_tass	.4114373	.3853241	1.07	0.286	-.3466878	1.169562
cash_ratio	-.0720047	.0781617	-0.92	0.358	-.2257878	.0817784
hpoll_ind	7.840852	2.651206	2.96	0.003	2.624606	13.0571
_cons	9.984329	19.73222	0.51	0.613	-28.8388	48.80746

The explaining variable *eudir* has clearly a significant positive effect on emission_policy, indicating that, on average, the companies affected by Directive 2014/95/EU increased and/or improved their policies aimed at limiting their activities impact on the environment in the last financial year with respect to the previous two years 2016-2017. However the t-test performed before had shown a limited change in the mean value of this dependent variable from years 2016-2017 to the year of regulatory application 2018. This explains why the overall positive but limited contribution of *Emission Reduction/Policy score* to *ESG combined Score* is not determinant, thus we observe a negative correlation between *esg_comb* and *eudir* in all the regression model specifications.

The Stata output reported in the following Table 7 is obtained with a regression model having one of the social-pillar-related scores as dependent variable. *Employment Quality/*

Employment Awards score is assigned to a company based on whether it has won an award or any prize related to general employment quality or "Best company to work for".

Table 7. *Stata output: regression of the dependent variable employment_quality, years 2016-2018.*

employment~y	Coef.	Robust Std. Err.	t	P>|t|	[95% Conf.	Interval]
eudir	-11.2561	1.445021	-7.79	0.000	-14.09918	-8.413024
audit	-.0187702	.0479553	-0.39	0.696	-.1131221	.0755817
roa	-.136879	.0966793	-1.42	0.158	-.3270954	.0533375
mcap_eq	.0120712	.0058097	2.08	0.039	.0006407	.0235017
ln_mcap	.1247968	.9633613	0.13	0.897	-1.770616	2.02021
tdebt_tass	-.012545	.0719317	-0.17	0.862	-.1540706	.1289805
capex_tass	-.0215713	.3768626	-0.06	0.954	-.7630484	.7199058
cash_ratio	.0085052	.055651	0.15	0.879	-.1009881	.1179985
hpoll_ind	-2.841664	2.463175	-1.15	0.250	-7.68796	2.004631
_cons	58.686	17.17982	3.42	0.001	24.88472	92.48728

The dependent variable *employment_quality* has the second highest and most significant coefficient of correlation with the dummy *eudir*, second only after the other dependent variable *emission_co2,* whose regression outcome is reported in Table 8. These two variables belong to different ESG pillars, but it's no coincidence that both of them consist in the only two pillars addressed by the European Directive 95. Indeed, the Governance pillar, differently from the Social and the Environmental ones, is not part of the minimum requirements of disclosure outlined in the regulation.

Table 8 presents the Stata results regarding the regression of *Emission Reduction/Innovative Production score* on the explaining variable *eudir* and eight control variables. This environmental-pillar-related score is indicating the extent to which a company reports on any of the following topics: the concentration of production locations in order to limit the environmental impact during the production process; the participation in any emission trading initiative; any new production technique implemented to improve the global environmental impact during the production process

Table 8. *Stata output: regression of the dependent variable emission_innovative, years 2016-2018.*

emission_i~e	Coef.	Robust Std. Err.	t	P>|t|	[95% Conf.	Interval]
eudir	-5.841342	1.204503	-4.85	0.000	-8.211202	-3.471482
audit	.1383145	.0618565	2.24	0.026	.0166119	.260017
roa	-.2478818	.1807799	-1.37	0.171	-.6035662	.1078026
mcap_eq	-.032014	.0127324	-2.51	0.012	-.0570651	-.006963
ln_mcap	4.276226	1.188809	3.60	0.000	1.937246	6.615207
tdebt_tass	-.0307436	.0903039	-0.34	0.734	-.2084165	.1469292
capex_tass	1.19471	.4820213	2.48	0.014	.2463329	2.143086
cash_ratio	.0589705	.0850296	0.69	0.488	-.1083251	.2262661
hpoll_ind	18.80468	3.147805	5.97	0.000	12.61138	24.99798
_cons	-34.72559	20.76078	-1.67	0.095	-75.57242	6.121235

The results implicate that even on this dependent variable the European CSR directive application had a diminishing effect in the first year of its application, in contrast with the expected output of the research model.

Table 9 presents the results of the last ESG-related score for which I found a significant correlation with the dummy variable eudir. The variable Emission Reduction/CO2 Reduction score measures a company's initiative to reduce, reuse, recycle, substitute, phase out or compensate CO2 equivalents in the production process.

Table 9. *Stata output: regression of the dependent variable emission_co2, years of observation 2016-2018.*

emission_co2	Coef.	Robust Std. Err.	t	P>|t|	[95% Conf.	Interval]
eudir	-19.23944	1.711383	-11.24	0.000	-22.60659	-15.87229
audit	-.004235	.0541509	-0.08	0.938	-.1107768	.1023068
roa	-.0987767	.1581041	-0.62	0.533	-.4098463	.212293
mcap_eq	-.0384714	.0157654	-2.44	0.015	-.0694897	-.0074531
ln_mcap	4.547002	1.027091	4.43	0.000	2.526202	6.567802
tdebt_tass	.0502578	.0826706	0.61	0.544	-.1123965	.2129121
capex_tass	1.114523	.3842097	2.90	0.004	.3585905	1.870455
cash_ratio	.0814585	.0763657	1.07	0.287	-.068791	.2317081
hpoll_ind	12.72452	2.730392	4.66	0.000	7.352474	18.09656
_cons	-25.54917	18.0077	-1.42	0.157	-60.97931	9.880976

The differing significance level of the various ESG components is further evidence that European Directive 95, enacted in 2014, is addressing only two out of three ESG pillars. Specifically, the minimum disclosure requirements imposed by the CSR regulation are "environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters", which refer to the Environmental and Social pillars. In fact, if Eikon database does not contain much information and indicators regarding the Governance pillar is because

companies didn't report about that in the last years, including fiscal year 2018. Furthermore some specific aspects of these two pillars have been addressed more than others in the first year of mandate application.

The overall results are clearly rejecting the initial hypothesis, according to which the application of the Directive should have led to an improvement of the CSR performance emerging from firms' annual reports. A plausible explanation to this outcome is that the first year of Directive application may represent a transitional year, in which affected companies were shifting their investments from the voluntary CSR activities on which they were previously investing to the activities relating to the areas which Directive 2014/95/EU obliges them to report about. Such a transition requires some time for the re-organization of resources and their deployment for newly examined and selected CSR activities.

Therefore, following the Directive application, firms CSR performance may go down only in the short-run, but this does not exclude that replicating the study in the next years may reveal positive consequences in terms of CSR performance. Indeed, recalling the 2018 article by Chen, Hung and Wang, mandatory CSR disclosure is likely to change firm behavior and to generate positive externalities to society thanks to a higher firms' exposure to public attention and a closer monitoring of its Environmental, Social and Governance activities by external stakeholders.

On the other hand, the opposition of my study results to the general expectations could be imputed to a statistical confounding problem caused by a regression model misspecification. In this case, confounding is attributable to omitted variables and/or to the use of a model which is not the most suitable for such a research question. Certainly, more research is needed regarding the EU Directive effects, not only with respect to firms' CSR performance but also to different potential consequences of economic or social nature. In order to answer my research question, considering a future greater availability of data for the years following the directive application, the adoption of a Diff-in-Diff model is recommendable as it would allow to better isolate the effect of mandated CSR disclosure from other external factors.

4. Conclusion

This work investigates the effect of CSR mandatory disclosure on firm CSR performance.

After examining various cases of CSR regulations mandating some CSR aspect in different worldwide countries, I focused on the European CSR context. Specifically, at the centre of my analysis I have placed Directive 2014/95/EU, whose application began in the last financial year 2018. It has imposed to EU public-interest entities with more than 500 employees to publicly

disclose information regarding some specific Environmental and Social matters, in a European context where CSR had already been playing a relevant role in supporting entrepreneurship and responsible business, especially with the renewed EU strategy 2011-14.

By means of an OLS regression model performed over 3 years 2016-2018, I answered the research question on whether the CSR disclosure mandate positively influenced the CSR performance of targeted EU companies in its very first year of application 2018.

The underlying assumption is the compliance of European firms with the Directive from the very first year of application, as proved for the Chinese 2008 CSR disclosure mandate (Wang et al., 2018) and explained by an increased exposure to public attention, which reduces the information asymmetry between firms' managers and the public.

Despite the positive expectations raised by the Chinese-regulation-related findings of diminishing effects on the environmental pollution (Chen et al., 2018), my statistical analysis results overall show that the CSR performance reported by European Companies in fiscal year 2018 has deteriorated with respect to the years of control 2016 and 2017, with an average decrease by 5.56%. After a deeper investigation on the performance of EU companies in different ESG areas, I also found that only some components related to the Environmental and Social pillar have a significant correlation with the variable representing the Directive application. Therefore, the Governance pillar, differently from the other two ESG pillars, did not contribute to the identified decrease in firm CSR performance, which is coherent with Directive 95 minimum disclosure requirements.

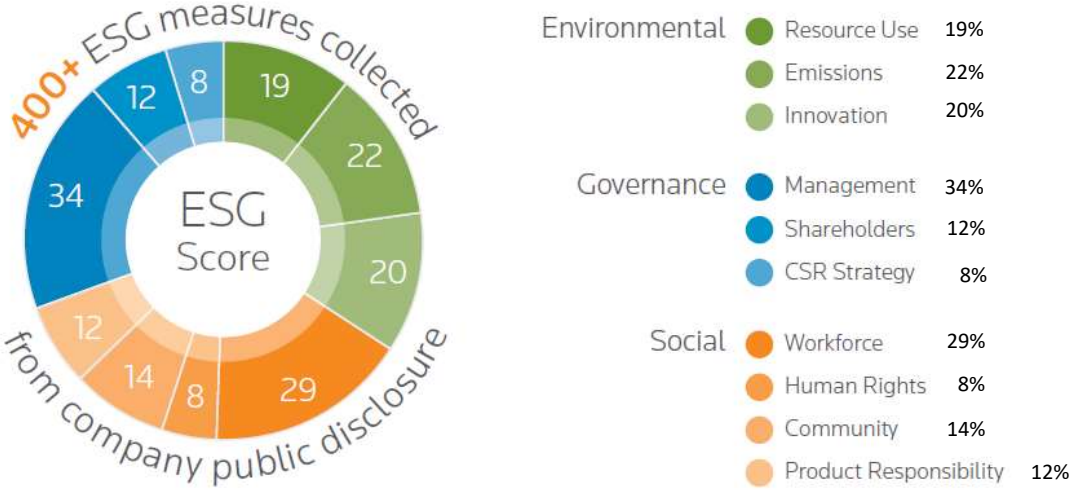
A plausible explanation to my study results is that the first year of Directive 2014/95/EU application may represent a transitional year, in which affected firms were still re-organizing their resources in order be able to invest in CSR activities relating to the areas which they are obliged to report about. If this was true, an enhanced ESG performance will emerge in the medium-long term, which would be consistent with the empirical findings of Chen, Hung and Wang (2018).

At the end, I recognize some limitations of the statistical model used which could generate a confounding problem. Thereby, for future research, with the availability of more years data, I suggest a strengthening of my study through the use of a Diff-in-Diff model which can potentially better isolate the effect of mandated CSR disclosure on CSR performance, thus proving whether or not the negative results were reliable.

Appendix 1. *ESG Score Composition*

The ESG pillars are grouped into 10 categories, reported in the *Graph1* below, that are given a specific weight to formulate the final ESG Score.

Graph1.



Thomson Reuters ESG categories. Source: *Thomson Reuters ESG scores* (2018).

Appendix 2. *Correlation Matrix of the statistical regression Independent Variables*

The independent variables correlation matrix is reported below with two different layouts, corresponding to different Stata commands. Table 10 shows the correlation coefficients for every possible combination of explaining variables pair. Table 11 reports only the variables correlation coefficients significant at the 5% level.

Table 10. *Stata output presenting the correlation matrix of all the independent variables*

	eudir	audit	roa	mcap_eq	ln_mcap	tdebt_~s	capex_~s	cash_r~o	hpoll_~d
eudir	1.0000								
audit	0.0088	1.0000							
roa	0.0007	-0.0148	1.0000						
mcap_eq	0.0166	-0.0218	0.0453	1.0000					
ln_mcap	-0.0219	-0.0971	0.0745	-0.0284	1.0000				
tdebt_tass	0.0068	0.1142	-0.0481	-0.0174	0.0486	1.0000			
capex_tass	0.0048	-0.0381	0.1606	0.0203	-0.0416	0.1198	1.0000		
cash_ratio	-0.0114	0.0131	0.1194	0.0124	-0.0604	0.1076	0.3131	1.0000	
hpoll_ind	0.0015	-0.0434	0.0891	-0.0142	-0.0700	0.0909	0.1803	0.2898	1.0000

Table 11. *Stata output displaying only correlation coefficients significant at the 5% level*

	eudir	audit	roa	mcap_eq	ln_mcap	tdebt_~s	capex_~s
eudir	1.0000						
audit	0.0088 0.7854	1.0000					
roa	0.0007 0.9821	-0.0148 0.6491	1.0000				
mcap_eq	0.0166 0.6088	-0.0218 0.5023	0.0453 0.1631	1.0000			
ln_mcap	-0.0219 0.5003	-0.0971 0.0027	0.0745 0.0215	-0.0284 0.3810	1.0000		
tdebt_tass	0.0068 0.8329	0.1142 0.0004	-0.0481 0.1386	-0.0174 0.5912	0.0486 0.1344	1.0000	
capex_tass	0.0048 0.8830	-0.0381 0.2406	0.1606 0.0000	0.0203 0.5320	-0.0416 0.2000	0.1198 0.0002	1.0000
cash_ratio	-0.0114 0.7248	0.0131 0.6860	0.1194 0.0002	0.0124 0.7027	-0.0604 0.0626	0.1076 0.0009	0.3131 0.0000
hpoll_ind	0.0015 0.9633	-0.0434 0.1816	0.0891 0.0059	-0.0142 0.6622	-0.0700 0.0309	0.0909 0.0050	0.1803 0.0000

	cash_r~o	hpoll_~d
cash_ratio	1.0000	
hpoll_ind	0.2898 0.0000	1.0000

Appendix 3. *Dependent Variables belonging to ESG Combined Score*

The meaning of each dependent variable, representing a component of *the ESG Combined Score*, is reported from Eikon database, as follows:

SCORE VARIABLE	MEANING
Health & Safety /Policy	Does the company have a policy to improve employee health and safety within the company and its supply chain?
Employment Quality/Employment Awards	Has the company won an award or any prize related to general employment quality or "Best company to work for"?

Board Structure/Monitoring	Does the company monitor the board functions through the establishment of a nomination committee?
Emission Reduction/Policy	Does the company have a policy for reducing environmental emissions or its impacts on biodiversity? And does it have a policy for maintaining an environmental management system?
Emission Reduction/Innovative Production	Does the company report on the concentration of production locations in order to limit the environmental impact during the production process? Or does the company report on its participation in any emission trading initiative? Or does the company report on new production techniques to improve the global environmental impact during the production process?
Emission Reduction/Environmental Compliance	All real or estimated penalties, fines from lost court cases, settlements or cases not yet settled regarding environmental controversies in US dollars.
Emission Reduction/CO2 Reduction	Does the company show an initiative to reduce, reuse, recycle, substitute, phase out or compensate CO2 equivalents in the production process?
Emission Reduction/Environment Restore Initiative	Does the company report or provide information on company-generated initiatives to restore the environment?

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