


Chapter 3

Unseen Link Between Sustainability Reporting and Financial Reporting: Behavioral Finance Paradigm

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ABSTRACT

The accounting profession has intensely witnessed compelling challenges in the 21st century. Due to increased number in stakeholders and huge informational need, the traditional model has become unsatisfactory in meeting this need and evaluating company's future performance. Apparently, companies trying to survive in globally competitive markets couldn't attain this goal by focusing merely on financial outcomes. Thus, sustainability reporting has emerged as a vital non-financial information demanded by stakeholders. However, ethical insights on credibility and accountability of this information have been documented and discussed in the literature. Tapping into behavioral finance paradigm and upper echelon approach, this chapter exerts an effort to link financial reporting/audit quality to sustainability reporting and discusses those ethical issues on these processes. Further, while drawing attention to overconfidence bias in individuals involved in reporting and assurance stages, it suggests influential role of decision-makers' personal traits on these mechanisms in a misleading way.

INTRODUCTION

In an increasingly changing and complex world, information, already important issue, has made a world of difference in early 2000s. Accounting and auditing scandals, market collapses following bubbles starting from US markets and expanding into nearly those of all financial markets have amplified the significance of the all relevant information, let alone financial information. This is because that companies trying to survive in a globally competitive markets couldn't attain this goal by focusing merely on

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financial outcomes. Therefore, suggesting a tool for companies to survive in this challenging environment, sustainability reporting (SR) has emerged as a vital non-financial information demanded by stakeholders. At the same time, the efforts to reduce information asymmetry, to deal with agency problems and further to improve stakeholder engagement/relation have led to discussing credibility and accountability of all this information meticulously.

On the other hand, extant research has heavily concentrated on quality, credibility of companies' financial reporting (FR) systems for two main reasons. First, audit quality (AQ) has been defined in terms of FR systems and measured frequently through FR indicators since traditional accounting approach toward reducing information asymmetry and dealing with principal-agent problems has predominantly overvalued financial information, shareholders and present investors. Therefore, AQ and FR quality have been used interchangeably. Second, accounting/auditing scandals, frauds occurred unprecedentedly in the 2000s have directed efforts of not only researchers but also businesses and regulatory bodies on this issue. Researchers started to explore audit/financial reporting quality, its determinants and consequences. Thereby, governments, accounting associations and other significant regulatory bodies all over the world have been striving to reconstruct confidence in the auditing/financial reporting functions through a series of ethical, disciplinary and institutional arrangements. However, on the other side, crucial sustainability issues such as climate change, human rights, governance and social well-being as mostly pronounced themes have urged companies in all countries to understand sustainability and empower their decisions concerning sustainability aspects both at national and also at international level. As such, in addition to financial information, non-financial information has gained prominence and stakeholders, future investors have been added as new counterparties in addition to shareholders and present investors for corporate communications and relations. Successively, sustainability indexes have been appeared in both developed and also developing countries' capital markets due to the investors who seek for sustainability components and apply to this criterion in their investment decisions. Ultimately, SR has come to the fore as common practice and worldwide trend in the 21st century.

These two substantial issues do not definitely compete in a horse race. Rather, there are both similarities and also key differences between them. First, both FR and SR systems share essentially the same mission; (1) reducing information asymmetry between counterparties in the markets and (2) showing how the reporting companies are functioning economically and to which degree this disclosed information –financial or non-financial is credible and to what extent these companies pay regard to their stakeholders, (3) dealing with principal-agent phenomenon, or currently deemed as stakeholder engagement. Second, both two reporting processes have some global guidelines or standards released by international regulatory bodies. Yet, as mentioned above, there are some major differences between them. In the first place, FR process addresses relatively narrower scope in terms of the limited nature of financial information and hence the span of stakeholder engagement while SR process appeals to broader scope and the increased number of outside users because of the wide and diversified nature of economic, environmental and social aspects. Second, FR is mandatory whereas SR is still voluntary. That's why, it can be said that independent auditors as assurance providers have engaged in an established audit market. Yet, assurance providers of SR have still been performing in an unsettled area. Third, extant research on financial reporting/auditing could be recognized as relatively matured and most popular whereas SR is ever-developing research area, compared to the former.

However, this matured research body lacks in delineating FR/AQ through audit partner specific or individual attributes since it has highly argued audit firm specific characteristics' role on it. This is interesting since this process is entirely decision-making process and the role of decision-makers seems

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