

Theoretical perspectives of corporate environmental disclosures in annual reports

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The past four decades has seen an evolution in community attitudes towards the environment in Australia (Lothian 1994). This change has corresponded with an increase in environmental legislation and program development within Australia and internationally (Bates 1995; Welford 1999). A number of researchers have noted a substantial increase in environmental disclosures in annual reports during this period (Guthrie & Parker 1989; Hogner 1982; Tinker & Neimark 1987). Within the environmental disclosure literature, several theoretical perspectives have been used to explain these changes in corporate environmental disclosure behaviour. This paper provides an overview of those perspectives.

Introduction

Many researchers have investigated the occurrence of corporate social and environmental disclosures in annual reports. In particular, the frequency and extent of environmental disclosures has increased substantially since the late 1960s and are now relatively common (Guthrie & Parker 1989; Hogner 1982; Tinker & Neimark 1987). The increase in environmental disclosures has corresponded with an increase in community concern regarding environmental matters.

Empirical research examining the occurrence of environmental disclosures in annual reports has identified a negative relationship between environmental performance and environmental disclosure. Corporations receiving low environmental performance ratings appear to have higher levels of environmental disclosures in annual reports (Rockness 1985). Furthermore, the quantity of environmental disclosures has been found to increase following the publication of negative environmental events such as spills and disasters (Deegan, Rankin & Voght 2000; Patten 1992), or the occurrence of fines and prosecutions from environmental protection agencies (Deegan & Rankin 1996; Li, Richardson & Thornton 1997).

While an increase in the disclosure of environmental performance information may appear useful, closer examination of the content of such disclosures has revealed a propensity for positive information (Deegan & Rankin 1996). Corporations provide little negative environmental information in the annual report even when the corporation has experienced negative environmental events. Of particular concern is the potential effect on users of environmental disclosures. In fact, empirical research has shown that users of annual reports can be misled regarding the environmental performance of corporations (Rockness 1985).

Several theoretical perspectives have been discussed within the environmental disclosure literature. A useful categorisation of theoretical perspectives for discussion purposes is provided by Gray, Kouhy and Lavers (1995b). Gray, Kouhy and Lavers (1995b) classify theoretical perspectives as decision-usefulness studies, economics-

based theories such as Positive Accounting Theory, and political economy theories. In view of the importance of social and environmental responsibility to the community, the use of economics-based theories within the disclosures literature has been criticised (Gray, Kouhy & Lavers 1995b). It is argued that a focus on self-interest and wealth-maximisation is inappropriate and offensive (Gray, Kouhy & Lavers 1995b). In contrast, political economy theories consider the political and social aspects of environmental disclosure behaviour along with the economic. Consequently, political economy perspectives including stakeholder theory and, to a greater extent, legitimacy theory have emerged as the dominant theoretical perspectives in the environmental disclosure literature. This paper provides an overview of the theoretical perspectives used in the environmental disclosure literature.

Political Economy Theory

The usefulness of political economy theories is that they do not focus solely on the economic self-interest and wealth-maximisation of the individual or corporation. Instead political economy theory (PET) considers 'the political, social and institutional framework within which the economic takes place' (Gray, Kouhy & Lavers 1995b, p. 52). Several empirical studies have identified an increase of social and environmental annual report disclosures that correspond with periods where those issues peaked in importance politically and/or socially (Hogner 1982; Guthrie & Parker 1989). As such, political economy theories seem to better explain why 'corporations appear to respond to government or public pressure for information about their social impact' (Guthrie and Parker 1990, p. 172).

The usefulness of political economy theory lies not only in its assessment of corporate disclosures as a reaction to the existing demands of stakeholders but in the way it 'perceives accounting reports as social, political and economic documents (Guthrie & Parker 1990, p. 166). Therefore, PET also recognises the use of social and environmental disclosures in annual reports as a strategic tool in achieving organisational goals, and in manipulating the attitudes of external stakeholders (Guthrie & Parker 1990).

Gray, Owen and Adams (1996) usefully classify PET into °classical° and °bourgeois° streams. Classical PET is linked to the works of Marx and the existence of class interest, power and conflict within society. Deegan (2000, p. 252) describes classical PET as:

[tending] to perceive accounting reports and disclosures as a means of maintaining the favoured position of those who control scarce resources (capital) , and as a means of undermining the position of those without scarce capital. It focuses on the structural conflicts within society.

Tinker and Neimark (1987) use the classical political economy approach in an examination of the use of annual reports within a capitalist society. They argue (1987, p. 72):

~corporate reports are not passive describers of an °objective reality°, but play a part in forming the world-view or social ideology that fashions and legitimises~the company°s annual reports were deployed as ideological weapons aimed at influencing the distribution of income and wealth, in order to ensure the company°s continued profitability and growth.

In contrast, the °bourgeois° political economy approach generally ignores °sectional (class) interests, structural inequity, conflict and the role of the State° and °is content to perceive the world as essentially pluralistic° (Gray, Kouhy & Lavers 1995b, p53). The pluralistic view adopted by the °bourgeois° PET ignores the existence of particularly powerful groups in society but tends to focus on the group interactions within °society° as a whole (Gray, Owen & Adams 1996). The application of stakeholder and legitimacy theory in the accounting and social and environmental disclosure literature has been described as *generally* being within a °bourgeois° political economy perspective (Gray, Kouhy & Lavers 1995b; Deegan 2000).

Stakeholder Theory

Stakeholder theory asserts that:

~the corporation's continued existence requires the support of the stakeholders and their approval must be sought and the activities of the corporation adjusted to gain that approval. The more powerful the stakeholders, the more the company must adapt. Social disclosure is thus seen as part of the dialogue between the company and its stakeholders~

(Gray, Kouhy & Lavers 1995b, p. 53).

The definition of 'stakeholder' has altered substantially over the past four decades. At one end of the spectrum the shareholder was considered the sole or principal stakeholder. This definition was based on arguments proposed by Friedman (1962) that the corporation's foremost objective is to maximise the wealth of its owners. Freeman (1983), however, expands the definition of stakeholder to include a broader selection of constituents including adversarial groups such as interest groups and regulators (Roberts 1992). Both the narrow (shareholder) and the expanded definition of stakeholders have been adopted in the development of mandatory environmental disclosure regulations for corporations. The Australian Democrats focussed on the interests of shareholders in amending the Corporations Law to include s. 299(1)(f). In proposing the amendment Senator Murray stated:

~many companies are materially affected financially in terms of environmental situations. I think we only have to recall some of BHP's financial consequences for environmental matters to be well aware of that~all those points I have laid out there will improve the nature of reporting which materially affects the value of shareholders' interest in companies~

(Senate Hansard, 24th June 1998, p. 4013)

In contrast, the Danish Parliament, *the Folketing*, adopted the broader definition of stakeholders for its Green Accounts Act. The Danish Environmental Protection Agency, which is responsible for supervision of the Green Accounts Act, includes as stakeholders customers, suppliers, local communities (and neighbours), professionals

and the public, employees, the press, authorities, interest groups and investors (Danish Environmental Protection Agency 2000, pp. 3-5).

Stakeholders control or have the ability to affect (directly or indirectly) control of resources required by the corporation. Thus, stakeholder power is determined by the level of control they have over the resources. The stakeholder-corporation power relationship is not generic across corporations (Deegan 2000). Power may take the form of command of limited resources (finances, labour), access to influential media, ability to legislate against the company, or ability to influence the consumption of the organisation's goods and services (Deegan 2000). Thus, when stakeholders control resources critical to the organisation, the company is likely to respond in a way that satisfies the demands of the stakeholders (Ullman 1985, p. 552). Ullman (1985) argues that organisations select the stakeholders that they want/need to consider, and the actions that they will take to achieve the desired relationship with those stakeholders.

Therefore, stakeholder theory is generally concerned with the way that an organisation *manages* its stakeholders (Gray, Dey, Owen, Evans & Zadek 1997, p. 333). As a result, Ullman (1985) argues that the power of stakeholders is related to the strategic posture adopted by the corporation. According to Ullman (1985, p. 552), an organisation's strategic posture describes the mode of response of an organization's key decision makers towards social demands. Therefore, stakeholder theory sees the world from the perspective of management (Gray, Kouhy & Lavers 1995b).

The way a corporation *manages* its stakeholders is dependent upon the strategic posture adopted by the corporation (Ullman 1985). Ullman (1985) argues that organisations may adopt an active or passive strategic posture. Corporations that adopt an active posture seek to *influence* [emphasis added] their organization's relationship with *important* [emphasis added] stakeholders (Ullman 1985, p. 552). It is important to note the specific reference to the important stakeholders. This reinforces the fact that companies with an active

posture not only identify stakeholders but must also determine those stakeholders with the greatest ability to influence the provision of resources to the corporation (Ullman 1985). In contrast, the corporation with a "passive" posture is "neither involved in continuous monitoring activities [of stakeholders] nor deliberately searching for an optimal stakeholder strategy" (Ullman 1985, pp552-553). The lack of stakeholder engagement inherent in a "passive" strategic posture is expected to result in "low levels of social disclosure" and "low levels of social performance" (Ullman 1985, p. 554).

Despite an extension beyond the economic and an acknowledgement of power relationships between the corporation and its stakeholders, Gray, Dey, Owen, Evans and Zadek (1997) argue that stakeholder theory is flawed because stakeholder theory focuses on the way the corporation *manages* its stakeholders. The corporation identifies the stakeholders that it will consider, and the level of attention it will give to each is based on how those stakeholders can *benefit* the organisation. They suggest that stakeholder theory is essentially a "market forces" approach in which resources and the provision/withdrawal of those resources determines the type of voluntary social disclosures at a given point in time (Gray, Dey, Owen, Evans and Zadek 1997). They argue that the "organization-centred legitimacy" of which stakeholder theory is reliant ignores important influences of society as a whole on the organisations provision of information. These include the existence of statute law and regulations developed by government and statutory bodies which contain requirements for information disclosure.

Legitimacy Theory

Many authors have discussed corporate environmental and social disclosure practices within the theoretical framework of legitimacy theory (see for example Wilmshurst & Frost 2000; Tilt 1994; Patten 1992; Guthrie & Parker 1989; Tinker & Neimark 1987; Hogner 1982). Dowling and Pfeffer (1975, p. 131) suggest that legitimacy theory is useful in analysing corporate behaviour:

~because legitimacy is important to organizations, constraints imposed by social norms and values and reactions to such constraints provide a focus for analysing organizational behaviors taken with respect to the environment.

Gray, Kouhy and Lavers (1995b) argue that legitimacy theory and stakeholder theory should be seen as overlapping, as opposed to competing theories. They explain that both perspectives are set within the framework of political economy theory. As the influence of society as a whole can affect the provision of financial and other resources to the firm, the firm utilises environmental performance and disclosure to justify or legitimise its activities to society. Unlike stakeholder theory which suggests that the corporation and its management acts and reports in accordance to the needs and power of its *separate* stakeholder groups (Ullman 1985), legitimacy theory focuses on the firm's interactions with society. Dowling and Pfeffer (1975, p. 122) provide a useful explanation of organisational legitimacy:

Organizations seek to establish congruence between the social values associated with or implied by their activities and the norms of acceptable behavior in the larger social system of which they are a part. Insofar as these two value systems are congruent we can speak of organizational legitimacy. When an actual or potential disparity exists between the two value systems, there will exist a threat to organizational legitimacy.

Underlying legitimacy theory is the "social contract" that exists between the firm and the society within which that firm operates and consumes resources. Shocker and Sethi (1974, p. 67) provide a regularly quoted explanation of the concept of "social contract":

Any social institution and business is no exception and operates in society via a social contract, expressed or implied, whereby its survival and growth are based on:

- 1) The delivery of some social desirable ends to society in general, and
- 2) The distribution of economic, social, or political benefits of groups from which it derives its power.

In a dynamic society, neither the sources of institutional power nor the needs for its services are permanent. Therefore, an institution must constantly meet the twin tests of

legitimacy and relevance by demonstrating that society requires its services and that the groups benefiting from its rewards have society's approval.

Dowling and Pfeffer (1975, p. 124) argue that legitimacy cannot be defined solely by what is legal or illegal. Society's expectations of corporate behaviour are both implicit and explicit (Deegan 2000, p. 254). Deegan (2000, p. 254) describes the explicit terms of the social contract as legal requirements, whereas the implicit terms are uncodified community expectations. The reason for the imperfect correlation between the law and societal norms and values is threefold (Dowling & Pfeffer 1975). Even though the law is often reflective of societal norms and values, the legal system may be slow in adapting to changes in norms and values in society. Furthermore, the legal system is based on consistency whereas norms may be contradictory. And finally, it is suggested that society may tolerate certain behaviours but not be willing to codify those behaviours in the legal system (Dowling & Pfeffer 1975).

Organisational legitimacy is something that is both conferred upon the corporation by society and something that is desired or sought by the corporation from society. As such, it has been argued that legitimacy may be seen as a potential benefit or resource to the organisation (Dowling & Pfeffer 1975; O'Donovan 2001).

Parties external to the entity confer legitimacy (Ashforth & Gibbs 1990; Dowling & Pfeffer 1975). Where a difference exists between the values of the corporation, and the values of the community, corporate legitimacy is threatened (Lindblom 1994; Dowling & Pfeffer 1975). This disparity between the entity's values and those of society is referred to as the legitimacy gap and may affect the corporation's ability to continue its operations (Dowling & Pfeffer 1975). Legitimacy gaps may occur when:

- There is a change in corporate performance but society's expectations of corporate performance remains unchanged

- Corporate performance is unchanged, but society's expectations of corporate performance have changed; and
- Corporate performance *and* society's expectations change in different directions, or in the same direction but with differing momentum

(Wartick & Mahon 1994).

However, it may be argued that the existence of and size of the legitimacy gap may not always be easy to determine.

O'Donovan (2001) suggests that where a disparity exists between the expectations of the corporation and those of its relevant publics the corporation will need to evaluate its social values and then align them with those held by the society in which it operates. Alternatively, the corporation may attempt to alter the existing social values or perceptions of the corporation as a legitimation tactic. In order to close the legitimacy gap, the entity must identify those activities that are within its control, and identify the relevant publics that have the power to provide the entity with legitimacy (Neu et al 1998).

Conclusion

During the past thirty years empirical researchers investigating social and environmental disclosures have explained the results within several theoretical perspectives. At times, the failure to adopt a single conceptual framework for social and environmental disclosure behaviour has resulted in criticism (Ullman 1985; Guthrie & Parker 1990). Gray, Kouhy and Lavers (1995b, p. 50) provide a useful categorisation of theoretical perspectives adopted in the existing literature. They identify three principal categories of theories being decision-usefulness theories, economic theories including Positive Accounting Theory, and political and social theories.

Decision-usefulness studies tend to fall into two broad categories (Gray, Kouhy & Lavers 1995b). First, these include studies that ask participants to rank items in terms of their importance, such as asking investors to rank the type of information they would like included in the annual report in order of importance (Epstein & Freedman 1994). Other decision-usefulness studies attempt to determine whether social responsibility information has an information value to financial markets or participants (Gray, Kouhy & Lavers 1995b). One example is the study undertaken by Shane and Spicer (1983) that analysed changes in security market returns following the public release of environmental performance ratings.

Positive Accounting Theory (PAT) is a positive theory made popular by Watts & Zimmerman (1986). Positive Accounting Theory is based on positive research which is an approach of analysing "what is" as opposed to the normative theory approach which analyses "what should be" (Deegan 2000). Watts and Zimmerman (1986, p. 7) define Positive Accounting Theory as:

[being] concerned with explaining accounting practice. It is designed to explain and predict which firms will and which firms will not use a particular method

Positive Accounting Theory is based on the wealth-maximisation and individual self-interest concepts underlying economic theory (Gray, Kouhy & Lavers 1995b). As such it is consistent with the argument that the primary responsibility of the corporation is "to use its resources and engage in activities designed to increase its profits" (Friedman 1962, p. 133). Hence, explaining the existence of social and environmental disclosure within the PAT framework provides a somewhat limited view of the phenomenon. A typical utilisation of PAT explains movements towards socially or environmentally responsible behavior and/or disclosure as being a result of market forces "that directs the self-interest of the entrepreneur into socially useful channels" (Abbott & Mosen 1979, p. 511).

While it would be unrealistic to ignore the presence of this behaviour, relying upon self-interest and expectations of wealth-maximisation as the main or sole motivation

for corporate environmental disclosures has been criticised (Gray, Kouhy & Lavers 1995b). Social and political factors also impact upon the corporation. Corporations operate within an environment of many constituents, often with conflicting aims and objectives (Oliver 1991). It is also noted that the sole responsibility of corporations is no longer perceived to be economic-performance-based (Epstein & Freedman 1994; Patten 1992; 1991). The community expects companies to act in a socially and environmentally responsible manner (Lothian 1994; Tinker & Neimark 1984). Consequently, the application of many economic theories, including PAT in the discussion of corporate social and environmental behaviour and disclosure has been described as 'not only empirically implausible but also highly offensive' (Gray, Kouhy and Lavers 1995b, p. 52).

The criticisms aimed at economics-based theories, including PAT have resulted in the increased popularity of political and social theories in the social and environmental disclosure literature (Gray, Kouhy and Lavers 1995b). These theories have become increasingly established over recent years.

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