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ARE CAPITAL MARKETS PUNISHING COMPANIES FOR THE LACK OF ESG TRANSPARENCY? ESG REPORTING AND THE EXPECTED RESPONSE OF MARKETS FROM INDEPENDENT REPORTS

Sinxuddin Istamov
Master's Student, Speciality of Corporate Finance and
Market Securities Banking and Finance Academy

Abstract

Among many questions still open in the growing academic literature regarding mandatory ESG reporting, one of the most important is whether capital markets react positively when firms issue their very first formal ESG report. In this paper, we present the background of our hypothesis that the issuance of the very first formal ESG compliant financial report leads to positive abnormal returns. Based on the principles of information asymmetry, signaling theory, and the relation of ESG reporting and cost of capital, we argue that firms issuing their first ESG report can benefit from a positive abnormal return due to decreased information asymmetry between the firm and ESG-oriented investors.

Keywords: ESG disclosure; capital markets; event study; abnormal returns; information asymmetry; cost of capital; signaling theory; first adoption; sustainability reporting.

1. Introduction

One reason behind the transition from voluntary ESG reporting to mandatory ESG reporting is the idea that auditable and standardized ESG reporting helps decrease the information asymmetry between companies and investors in capital markets and improves resource allocation and reduces the cost of capital for firms with good ESG performance. Under this rationale, the issuance of the first ESG-compliant financial report should be an important piece of information because it allows investors to access high-quality and comparable ESG information. This research paper investigates whether there is empirical evidence in favor of the hypothesis that there will be a positive reaction of the market to the issuance of the first ESG-compliant report.

2. Theoretical Foundations

There are three theoretical foundations supporting the assumption of positive capital market reactions to first ESG-compliant reports. According to information asymmetry theory, based on the research by Akerlof (1970) and Grossman & Stiglitz (1980), the disclosure of information should decrease the information asymmetry between insiders, having the access to the information, and the outsiders who do not have it, thus reducing investors' risk premium and hence, the cost of capital. In case of ESG information, it seems especially relevant because of the well-known problems in obtaining assured non-financial information through voluntary reporting.

In accordance with signalling theory, companies that have good ESG performance will signal their quality via costly, credible disclosure of information which corresponds to the type of assured, compliant report according to CSRD and IFRS S1/S2. From such perspective, first ESG-compliant reports can be viewed as credible signals, decreasing adverse selection in ESG-oriented capital markets and attracting institutional investors with ESG objectives.

Indeed, empirical research on the relationship between ESG and cost of capital supports these predictions. For instance, Cheng et al. (2014) establish that increased engagement in CSR leads to lower capital constraints and easier access to finance. In addition, Krueger et al. (2020) show that there is an increasing trend whereby institutional investors with ESG mandates, which constitute more than 35% of the global AUM, reduce their investments in companies characterized by poor ESG disclosure. Furthermore, El Ghoul et al. (2011) discover the existence of a statistically significant negative correlation between ESG and cost of equity capital.

3. Evidence from Similar Disclosure Events

While no direct evidence of market reactions to the introduction of ESG-compliant reports is available because such frameworks were only recently introduced as a legal requirement, evidence from similar disclosure events can be used as a reference point. Studies of the introduction of the first IFRS show considerable positive abnormal returns on the day when the first IFRS compliant report was released, which is explained by decreased information asymmetry and increased comparability (Horton et al., 2013). Research into the introduction of voluntary ESG disclosures, in which firms publish the first report on sustainability, shows mixed but overall positive abnormal returns during a small window following publication, with the size of the abnormal return dependent on the firm size, institutional ownership, and credibility of the disclosure (Ioannou & Serafeim, 2017). Given the higher credibility of mandated disclosure as compared to voluntary ones, it can be assumed that market reaction to the former will be even stronger.

4. Research Hypotheses and Research Methods

Based on the literature review and analogical studies, the following research hypotheses are formulated for the upcoming empirical study:

–H1: First-time issuers of an ESG-compliant financial statement would show significant positive cumulative abnormal returns (CARs) in the event window around the issuance, as a result of reduction in information asymmetries.
–H2: Positive CARs would be significantly larger for firms operating in highly ESG-sensitive industries (energy, financial services, utilities) as compared to those operating in less sensitive industries, due to the difference in investor demand for ESG information.
–H3: Among the first adopter sample, firms with better quality of ESG information in the first year would show larger positive CARs and reduction in the implied cost of equity capital during the next 12 months after initial disclosure.
The hypotheses stated above will be tested through the event study approach, employing a sample consisting of EU, US, and emerging market firms which publish their first ISSB-compliant or CSRD-compliant ESG report during the period from 2021 to 2024. The abnormal returns will be calculated by the use of the market model, taking into account the 200-day estimation window and event window of [−5, +20]. The ESG Disclosure Quality Scores will be developed based on the reports issued using the GRI and ISSB materiality criteria, coded by raters.

5. Conclusion

Based on theory and empirical evidence alike, it can be stated that a positive market reaction is expected due to reduction of information asymmetry and ESG disclosure quality signals to the ESG sensitive investors. It is expected to be conditioned by the ESG sensitivity of the industry and ESG disclosure quality level, thereby providing a financial motivation for a firm to make a substantial effort to develop the high-quality ESG report at the very beginning, rather than minimum compliance reporting. The results from the empirical analysis will be presented in the forthcoming Master's thesis.

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