Effect of Sustainability Reporting on Financial Performance of Firms Listed at the Nairobi Securities Exchange, Kenya

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ABSTRACT

This study examined the effect of sustainability reporting on the financial performance of firms listed at the Nairobi Securities Exchange, Kenya. A descriptive panel research design was adopted and a census of the 64 listed firms was targeted, of which 44 firms with complete annual reports and market data for 2021–2025 were retained, yielding a balanced panel of 220 firm-year observations drawn from all ten sectors of the exchange. Secondary data were extracted from annual, integrated and sustainability reports, audited financial statements and NSE price lists. Sustainability reporting was measured through an Environmental Reporting Index, a Social Reporting Index and a Governance Disclosure Index derived from a Global Reporting Initiative checklist; financial performance was measured by Tobin's Q; and firm size, measured by the natural logarithm of total assets, was the control variable. The regression-based Hausman test was significant, supporting fixed effects as the preferred model. The Environmental Reporting Index and the Social Reporting Index had positive and statistically significant effects on Tobin's Q, and both remained significant and stable under pooled, random-effects, year-effects and composite-index specifications. The Governance Disclosure Index was positive but significant only at the 10 percent level reflecting the near-universal disclosure of governance items that are already mandatory for listed firms. Firm size had a small positive and significant effect that disappeared once year effects were included. The fixed-effects model was jointly significant and explained 74.4 percent of within-firm variation in Tobin's Q. The study concludes that sustainability reporting, through its environmental and social dimensions, improves the market-based financial performance of firms listed at the Nairobi Securities Exchange, and that governance disclosure has become a baseline expectation that no longer differentiates firms. Listed firms should close the remaining gaps in environmental and social disclosure, quantify and obtain assurance of what they report, and integrate sustainability information into investor communication, while the Capital Markets Authority, the Nairobi Securities Exchange and the Institute of Certified Public Accountants of Kenya should accelerate the transition to mandatory reporting under IFRS S1 and IFRS S2 with assurance, standardized metrics and investor education.

Keywords: Sustainability Reporting; Financial Performance: Governance Disclosure

INTRODUCTION

Sustainability reporting has become an important corporate practice that enables firms to disclose their environmental, social, and governance activities to stakeholders (Alsayegh et al., 2024). Sustainability reporting refers to the disclosure of environmental, social, and governance information alongside financial information to demonstrate an organization's economic, environmental, and social performance (Odintsova, 2024). It is also defined as the systematic communication of sustainability-related policies, practices, and outcomes to stakeholders to enhance transparency and accountability (Ferreira et al., 2025). Ho et al. (2024) describe sustainability reporting as an integrated reporting approach that enables stakeholders to assess an organization's long-term value creation. In this study, sustainability reporting referred to the extent to which a firm disclosed environmental, social, and governance information in its annual and sustainability reports because such disclosures reflect corporate transparency and accountability.

This study measured sustainability reporting using the Environmental Reporting Index, Social Reporting Index, and Governance Disclosure Index developed from the Global Reporting Initiative disclosure checklist because the approach provides an objective and transparent assessment of sustainability disclosures across firms. This measure has also been used before by Agutu and Githira (2023). Financial performance refers to the ability of a firm to utilize its resources efficiently to generate returns and achieve its financial objectives (Saeed et al., 2023). It is also described as the extent to which an organization creates economic value through efficient management of its assets and operations (Ahmad et al., 2025). According to Attah-Botchwey et al. (2022), financial performance reflects the financial outcomes achieved from managerial decisions and organizational activities.

This study measured financial performance using Tobin's Q, a market-based measure computed as the market value of equity plus the book value of total liabilities divided by the book value of total assets. Tobin's Q was preferred because it is forward-looking, reflects how investors at the Nairobi Securities Exchange price a firm's sustainability disclosures, and is less susceptible to accounting policy choices and managerial discretion than accounting-based measures such as return on assets. This measure has also been used before by Agutu and Githira (2023).

Research Problem

Sustainability reporting has become an important corporate practice because it enhances transparency and strengthens stakeholder confidence, with firms that disclose environmental, social, and governance (ESG) information expected to attract investors, improve their reputation, and achieve better financial performance (Alessa & Durand, 2024; Ho et al., 2024). Conceptually, however, prior studies have examined this relationship in a fragmented manner rather than treating sustainability reporting as a composite of its environmental, social, and governance dimensions. Chen et al. (2023) relied on aggregate ESG performance ratings, Ferreira et al. (2025) examined sustainability reporting from the perspective of accounting information quality rather than financial performance, and Ali et al. (2022) treated ESG disclosure merely as a mediating variable in the environmental management–performance relationship. Similarly, Ndung'u and Onyuma (2023) linked social sustainability reporting to organizational efficiency rather than financial performance, while Mwangi et al. (2023) considered only governance disclosure, leaving the environmental and social dimensions unexplored. This constituted a conceptual gap because no known study had simultaneously examined environmental, social, and governance reporting and their combined effect on financial performance, a gap this study sought to address.

Empirical evidence on the relationship between sustainability reporting and financial performance remains inconclusive, with studies reporting positive, negative, and insignificant associations (Chen et al., 2023). Methodologically, these studies have adopted divergent measures and analytical approaches; some relied on subjective third-party ESG ratings, while others employed cross-sectional designs and single-period data that cannot capture the dynamic and lagged effects of disclosure on performance over time. Few studies have applied panel data techniques or drawn on recent reporting periods, which limits the reliability and comparability of their findings.

This represented a methodological gap because the effect of sustainability reporting on financial performance had not been adequately examined using recent panel data that account for both cross-sectional and time-series variation among listed firms. To address these gaps, this study examined the effect of sustainability reporting on the financial performance of firms listed at the Nairobi Securities Exchange using panel data for the period 2021–2025. Accordingly, the study sought to answer the following research question: what is the effect of sustainability reporting on the financial performance of firms listed at the Nairobi Securities Exchange, Kenya?

Research Objective

The objective of this study was to establish the effect of sustainability reporting on the financial performance of firms listed at the Nairobi Securities Exchange, Kenya.

THEORETICAL REVIEW

The study was anchored on Stakeholder Theory and was supported by the Triple Bottom Line Theory and Agency Theory, which collectively explain how environmental, social, and governance reporting is expected to influence financial performance.

Stakeholder Theory

Stakeholder Theory was developed by Freeman (1984), who argued that organizations should create value for all stakeholders rather than focusing exclusively on shareholders. The theory posits that managers should consider the interests of employees, customers, suppliers, investors, governments, and communities when making strategic decisions because these groups influence organizational success (McGahan, 2023). The theory further maintains that responding to stakeholder expectations enhances organizational legitimacy, trust, and long-term performance (Valentinov & Roth, 2024).

Stakeholder Theory was the anchor theory for this study because sustainability reporting is primarily intended to satisfy the information needs of multiple stakeholder groups. The theory predicts that firms providing comprehensive environmental, social, and governance disclosures are more likely to strengthen stakeholder confidence, enhance corporate reputation, and improve financial performance through increased stakeholder support (Ramoglou et al., 2023). Similarly, effective stakeholder engagement has been shown to enhance the value derived from sustainability initiatives, reinforcing the expected positive relationship between sustainability reporting and financial performance (Adardour, 2025).

Despite its wide application, Stakeholder Theory has attracted criticism on several grounds. Critics argue that the theory does not clearly identify which stakeholder interests take priority when competing demands should arise, making managerial decision-making difficult (Sternberg, 2019). Others contend that the theory provides limited guidance on balancing stakeholder expectations with financial objectives, thereby reducing its predictive power in practice (Stoelhorst & Vishwanathan, 2024). Nevertheless, the theory remained appropriate for this study because sustainability reporting is fundamentally designed to enhance accountability and transparency to a broad range of stakeholders.

Triple Bottom Line Theory

Triple Bottom Line Theory was introduced by Elkington (1997), who argued that organizational success should be assessed using three dimensions: environmental, social, and economic performance. The theory proposes that firms should pursue profitability while simultaneously protecting the environment and promoting social well-being because sustainable development depends on balancing these three dimensions (Del Gesso, 2025). It therefore shifts organizational performance assessment beyond traditional financial measures to include broader sustainability outcomes.

The Triple Bottom Line Theory supported this study by explaining the environmental and social dimensions of sustainability reporting. The theory predicts that firms integrating environmental stewardship and social responsibility into their reporting practices are more likely to improve stakeholder relationships, strengthen corporate reputation, and enhance financial performance over the long term (Öztürk & Bağış, 2025). Consequently, greater environmental and social disclosures were expected to contribute positively to financial performance through sustainable value creation.

Despite its widespread acceptance, the theory has been criticized for placing equal emphasis on environmental, social, and economic objectives despite the practical difficulty of balancing these competing goals (Hossain & Hasan, 2024). Critics also argue that the theory lacks standardized measures for evaluating the three dimensions, resulting in inconsistencies across organizations and studies (Zharfpeykan & Harrison, 2026). Nevertheless, the theory remained relevant because it provided the conceptual foundation for examining the environmental and social reporting dimensions of sustainability reporting.

Agency Theory

Agency Theory was developed by Jensen and Meckling (1976), who argued that conflicts arise when managers pursue personal interests that differ from those of shareholders. The theory posits that information asymmetry and the separation of ownership from control create agency costs that reduce organizational efficiency (Davis et al., 2021). It further suggests that effective governance mechanisms and transparent disclosures reduce agency conflicts by enhancing accountability and monitoring (Andreou et al., 2023).

Agency Theory supported this study by explaining the governance dimension of sustainability reporting. The theory predicts that firms providing transparent governance disclosures reduce information asymmetry, strengthen investor confidence, and improve financial performance through enhanced managerial accountability (Ahmad et al., 2025). Similarly, strong governance structures minimize agency problems and promote efficient decision-making, thereby contributing to improved organizational performance (Asimakopoulos et al., 2025).

Despite its widespread application, Agency Theory has been criticized for assuming that managers are primarily motivated by self-interest, thereby overlooking ethical behaviour and stewardship motives that may influence managerial decisions (Aluchna, 2023). The theory has also been faulted for placing excessive emphasis on shareholder interests while giving limited attention to other stakeholders who influence organizational success (Cheah & Tan, 2024). Furthermore, its assumptions may not adequately explain sustainability reporting, which often seeks to create value for multiple stakeholder groups beyond shareholders (Ullmann, 1985). Nevertheless, the theory remained relevant because governance disclosures were expected to reduce agency conflicts and enhance financial performance.

METHODS

The study adopted a descriptive panel research design. A descriptive design was appropriate because it enabled the researcher to examine and explain the relationship between sustainability reporting and financial performance without manipulating the study variables. The target population for this study comprised all the 64 firms listed at the Nairobi Securities Exchange as at December 2025.

The study relied exclusively on secondary data collected from the published annual reports, sustainability reports, integrated reports, and audited financial statements of firms listed at the Nairobi Securities Exchange for the period 2021 to 2025. Sustainability reporting data were extracted using the sustainability disclosure checklist. The study employed panel regression analysis. The panel regression model was specified as follows:

$$Yit = \beta0 + \beta1X1it + \beta2X2it + \beta3X3it + \beta4X4it + \varepsilon it$$

Where:

Yit = Financial performance of firm i at time t, measured by Tobin's Q.

$\beta0$ = Constant term

$\beta1 - \beta4$ = Regression coefficients

$X1it$ = Environmental Reporting Index

$X2it$ = Social Reporting Index

$X3it$ = Governance Disclosure Index

$X4it$ = Firm size

εit = Error term

RESULTS

The table below presents the preferred fixed-effects model estimated in accordance with the analytical model. The Table 1 reports coefficients, clustered standard errors, t-statistics, p-values and 95 percent confidence intervals, followed by the model-fit statistics.

Table 1: Fixed-Effects Panel Regression Results

Variable	β	Std. Error	t	p-value	95% CI
Constant	−0.9415	0.7685	−1.225	0.222	[−2.4584, 0.5754]
Environmental Reporting Index	0.5081	0.0295	17.216	<0.001	[0.4498, 0.5663]
Social Reporting Index	0.2937	0.0352	8.342	<0.001	[0.2242, 0.3631]
Governance Disclosure Index	0.1053	0.0537	1.961	0.051	[−0.0007, 0.2113]
Firm size	0.0676	0.0316	2.139	0.034	[0.0052, 0.1300]
Observations	220				
Firms	44				
R^2 (within)	0.744				
F statistic (4, 172)	125.245			<0.001	
Robust F statistic	144.449			<0.001	

Note: Dependent variable is Tobin's Q. Standard errors are clustered by firm. The within R^2 is the relevant goodness-of-fit measure for the fixed-effects estimator.

The model was jointly significant ($F = 125.245$, $p < 0.001$; robust $F = 144.449$, $p < 0.001$) and explained 74.4 percent of the within-firm variation in Tobin's Q. The high within R^2 indicates that changes in a firm's sustainability disclosure and size over the period accounted for most of the year-to-year change in its market valuation relative to the book value of its assets. The estimated model was therefore:

$$TQ_{it} = -0.942 + 0.508\ ERI_{it} + 0.294\ SRI_{it} + 0.105\ GDI_{it} + 0.068\ SIZE_{it}$$

The Environmental Reporting Index had a coefficient of 0.508 ($p < 0.001$) with a confidence interval of [0.450, 0.566] that lay entirely above zero. Holding social reporting, governance disclosure, firm size and all stable firm characteristics constant, a firm that moved from disclosing none to disclosing all seven environmental items would be associated with a Tobin's Q higher by 0.508, or about 35 percent of the mean. In more practical terms, disclosing one additional environmental item, which raises the index by one seventh, was associated with an increase of about 0.073 in Tobin's Q, and a typical within-firm change in the index of one standard deviation (0.165) corresponded to an increase of about 0.084.

The Social Reporting Index had a coefficient of 0.294 ($p < 0.001$) with a confidence interval of [0.224, 0.363]; one additional social item disclosed was associated with an increase of about 0.042 in Tobin's Q. Environmental and social reporting therefore had positive and statistically significant effects on financial performance at the 1 percent level.

The Governance Disclosure Index had a positive coefficient of 0.105 but was significant only at the 10 percent level ($p = 0.051$), with a confidence interval of [−0.001, 0.211] whose lower bound just touched zero. At the 5 percent level adopted in Section 3.5.4, governance disclosure therefore did not have a statistically significant effect on financial performance, although the estimate is positive and the result is marginal rather than null.

Firm size was positive and significant ($\beta = 0.068$, $p = 0.034$); a 10 percent increase in total assets within a firm, equivalent to about 0.095 log units, was associated with an increase of about 0.006 in Tobin's Q, a small effect relative to those of the disclosure indices.

Table 2 presents the coefficients and fit statistics, with clustered standard errors in parentheses.

Table 2: Comparison of Panel Estimators and Alternative Specifications

Variable/statistic	Pooled OLS	Random effects	Fixed effects	Fixed effects with year effects	Fixed effects, composite index
Environmental Reporting Index	0.459***	0.519***	0.508***	0.488***	
	-0.048	-0.03	-0.03	-0.034	
Social Reporting Index	0.282***	0.302***	0.294***	0.268***	
	-0.064	-0.035	-0.035	-0.041	
Governance Disclosure Index	0.132	0.113*	0.105	0.071	
	-0.084	-0.052	-0.054	-0.065	
Composite sustainability index					1.123***
					-0.065
Firm size	0.006	0.014	0.068*	−0.025	0.099*
	-0.015	-0.015	-0.032	-0.057	-0.04
Constant	0.584	0.354	−0.942	1.372	−1.929*
	-0.37	-0.365	-0.769	-1.393	-0.949
Relevant R^2	0.347	0.339 overall	0.744 within	0.727 within	0.673 within
Model statistic	F = 28.557	F = 122.472	F = 125.245	F = 71.446	F = 179.362
	(p < 0.001)	(p < 0.001)	(p < 0.001)	(p < 0.001)	(p < 0.001)
Observations	220	220	220	220	220

Note: Clustered standard errors in parentheses. * $p < 0.05$; *** $p < 0.01$. Fixed effects is preferred by the Hausman test.

The environmental and social reporting coefficients were positive and significant at the 1 percent level in every estimator and specification, and their magnitudes were stable, ranging from 0.459 to 0.519 for environmental reporting and from 0.268 to 0.302 for social reporting. Most importantly, both remained significant and of similar size when year effects were added, which demonstrates that the results were not an artefact of the simultaneous market-wide rise in disclosure and valuation between 2021 and 2025; firms whose disclosure improved more than the market average in a given year were revalued more than the average. The composite index was also strongly significant ($\beta = 1.123$, $p < 0.001$), confirming that the result did not depend on examining the dimensions separately. The positive effect of sustainability reporting on financial performance is therefore robust.

The governance disclosure coefficient was positive in every specification but significant at the 5 percent level only under random effects ($p = 0.030$); it was marginal under fixed effects ($p = 0.051$) and insignificant once year effects were added ($p = 0.275$). The governance result is therefore fragile and is best characterized as a small positive association that the available variation in governance disclosure is insufficient to establish with confidence. The firm size coefficient was positive and significant in the fixed-effects models but close to zero in the pooled and random-effects models and when year effects were included, which indicates that the within-firm size effect largely reflected the common growth of balance sheets and valuations over the period rather than a firm-specific reward for scale. Because the Hausman test selected fixed effects, the fixed-effects magnitudes receive primary emphasis, with these qualifications

CONCLUSION

The study concludes that sustainability reporting has a positive and statistically significant effect on the financial performance of firms listed at the Nairobi Securities Exchange, Kenya, and that the effect is identified within firms over time rather than merely across firms that differ in kind. The conclusion is conditional in three

respects that follow directly from the evidence. It is driven by the environmental and social dimensions of reporting, since the governance dimension displayed too little variation to be rewarded separately; it holds for a period in which sustainability reporting was expanding rapidly from a low base under a voluntary guidance regime, so that improvements in disclosure carried genuine new information for investors; and it holds for the breadth of disclosure as measured by a binary checklist and for market-based performance, since the study did not examine the quality or assurance of what was disclosed or its effect on accounting returns. The evidence therefore supports the conclusion that, in a frontier market moving toward mandatory sustainability reporting, investors reward firms that disclose more environmental and social information, and that the market benefit of sustainability reporting is real, economically material and not confined to financial institutions.

RECOMMENDATIONS

Boards and managers of listed firms should treat environmental reporting as a value-relevant disclosure and should prioritize closing the gaps in it, since environmental reporting had the largest effect on market valuation and remains the least complete of the three dimensions, with firms disclosing on average only five of seven items. Firms should disclose quantified Scope 1 and Scope 2 emissions, energy and water intensity, waste management, sustainable sourcing, biodiversity impacts and green financing activities against stated targets and prior-year performance, align those metrics with the IFRS S2 requirements that will become mandatory in 2027, and obtain independent assurance of the environmental information presented. The evidence indicates that each additional environmental item disclosed was associated with a measurable increase in Tobin's Q, so that the cost of environmental reporting systems is likely to be recovered through a lower cost of capital and higher market valuation.

Firms should strengthen social reporting and integrate it with their investor communication. Because social disclosure was consistently rewarded by the market, firms that report credibly on labour practices, human rights, workforce diversity, health and safety, training and customer responsibility should expect to be valued more highly, and the reward is likely to grow as the information becomes more quantified and comparable. Managers should present social disclosures in a form that investors can use, by linking them to operational outcomes such as staff retention, productivity, safety incident rates, customer satisfaction and the management of reputational and regulatory risk, and by discussing them in results briefings and investor presentations rather than confining them to a separate sustainability section of the annual report.

The Capital Markets Authority and the Nairobi Securities Exchange should recognize that governance disclosure has reached a ceiling among listed firms and should direct regulatory attention toward the quality and effectiveness of governance rather than the presence of disclosures. Since almost all firms already disclose board composition, remuneration, audit oversight, shareholder rights and compliance, further requirements to disclose these items will not improve the information available to investors. The regulators should instead require listed firms to report on board evaluation outcomes, the effectiveness of ESG oversight structures and any departures from the governance code with explanations, and the exchange should consider incorporating governance effectiveness, rather than governance disclosure alone, into its ESG scoring of listed firms.

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