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## Sustainability Reporting and Financial Performance for Listed Commercial Banks at the Nairobi Securities Exchange – Kenya

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### Abstract

Sustainability reports have become important tools in recent years for companies to measure their environmental performance and achieve sustainable development. Still, the influence of sustainability reporting on a company's financial returns varies, with certain companies experiencing progress while others observe no discernible effect. Despite the importance of sustainability reporting, there are few studies on the impact of sustainability reporting on corporate financial performance of banks listed on the NSE. Given this, the purpose of this study was to ascertain how sustainability reporting affected the financial results of commercial banks that were listed on the Nairobi Securities Exchange. This research used agency theory, stakeholder theory, and signaling theory to guide its research. A descriptive exploratory design was employed in this study, focusing on the 11 NSE-listed banks that collectively employ 23,534 individuals. The population was divided into secretarial, clerical, supervisory, and management strata using stratified random sampling. Data was collected through questionnaires (primary method) and through data collection instruments (secondary method). The data was later coded, entered, cleaned, and analyzed using SPSS version 28. Descriptive statistical measures, including means, percentages, and frequencies were employed to summarize and characterize the sample data. Inferential statistical techniques such as correlation and regression were also applied to derive conclusions and make inferences beyond the observed sample results. The results of this study show a clear connection between the disclosure of environmental information and the financial performance of banking institutions. The banks placed emphasis on environmental sustainability through various initiatives such as clean energy and waste management. However, the study also found that a comprehensive shift toward environmentally friendly practices has yet to occur. This study adds value to the current scholarly discourse by improving our understanding of the connection between sustainability reporting and financial performance.

**Key words:** *Sustainability, Reporting, Environmental Sustainability, Financial Performance, Listed Commercial Banks*

### 1. Introduction

In accordance with Gray (2000), sustainability reporting is a sub-discipline of financial accounting, encompassing all non-financial accounts. Idowu, Filho, and Walter (2009) state that the concept of sustainability reporting dates back to the 1970s. It involves analyzing a company's performance and communicating its non-financial information to external stakeholders. Based on Perrini & Tencati (2006), accounting for sustainability benefits businesses by allowing them to increase their profitability. Additionally, businesses become more sustainable by recognizing the importance of sustainability and by ensuring transparency in their reporting. Apart from this, sustainability also plays a crucial part of a company's strategy to enhance its long-term viability.

Sustainability reporting strategies can also provide organizations with a better understanding of their risks and opportunities. Based on the above, this helps the organisation to align their strategies and actions with their corporate objectives (Ecovadis, 2021). ESG reporting aids organizations to prevent or minimize environmental, social, and economic challenges. Additionally, it can also help a company compare itself against other companies in the same industry (Sonal, 2013).

Several international organizations guide on how to develop and implement sustainable reporting. These include the OECD, the UN Global Compact, and the ISO. Businesses and organizations can develop and implement sustainable reporting standards through this group. They can also share their experiences and knowledge with other businesses. The GRI guideline is perhaps the most extensively used global benchmark for assessing and reporting on social, governance, and environmental issues (KPMG, 2020).

The number of businesses producing sustainability reports has increased in complexity over the last few years. Various institutions such as the World Economic Forum have provided businesses with tools that they can now use to improve their reporting (WEF, 2020). Additionally, the European Union has also established requirements for companies to report on their sustainability efforts and has set the implementation dates for the sustainability requirements to be October 2022 (Union euro penne, 2020). Other Institutions such as Deloitte (2020) note that various international organizations such as CDP, SASB, IIRC,

and GRI have joined forces to develop regulations to help companies disclose their sustainability performance. In addition, the IFRS Foundation published a discussion paper to develop global standards for sustainability reporting in 2020.

Despite the difficulties associated with implementing voluntary disclosure frameworks in Sub-Saharan Africa, they assist in reducing disparities in sustainability. Mumbi, Berndt, & Romero (2020) confirm that South Africa is the only country that requires all companies to report on sustainability. All companies listed on the JSE must submit an integrated report. According to The Conversation (2016), integrated reports must include both the financial and the non-financial data. Mahadeo & Soobaroyen (2013) also state that businesses in South Africa must adhere to stricter reporting requirements.

The Egyptian stock exchange does not necessitate companies to provide extensive sustainability efforts. Nevertheless, a strong corporate code of professional conduct is required to ensure that companies are transparent and accountable. It is also possible to strengthen the stock exchange regulation by granting it more powers. This would allow it to implement effective and efficient measures (Egyptian Securities Exchange, 2020).

Songi & Dias (2019) note that, even though sustainability reporting is broad and extensive, it's indeed voluntary in Botswana. The King report requirements assist companies in meeting the Botswana Code of Conduct requirements. In Equatorial Guinea, reporting on sustainability is entirely voluntary, and it is supported by global standards such as the GRI. Numerous studies have demonstrated that self-regulation is unlikely to be effective in securing robust sustainability and long-term viability.

In Kenya, there are three main methods for sustainability reporting. These include applying or explaining, complying or otherwise, and compliance or explaining (Ngatia, 2014). Kenya is required to provide comprehensive information on its sustainability efforts as part of its membership in the Eastern African Community (EAC, 2014). According to the data released by the Nairobi Securities Exchange, about 86% of companies listed on its platform reported their social responsibility performance in 2006 (NSE, 2006). According to a study conducted by the Kenya Climate Innovation Centre (2020), workers significantly impact companies adopting sustainable practices. Sixty per cent of Kenyans prefer to purchase products from businesses that engage in environmentally friendly practices. By 2022, Kenyans will desire to favour businesses committed to enhancing their sustainability performance (Mungai, 2020).

An organization's environmental sustainability is a process that involves reducing its carbon footprint and improving the air quality in its facilities (JOURMARD, 2009). An organization's environmental sustainability activities aim to improve the air quality of its facilities and reduce its greenhouse gas emissions (HUTTMANOV, 2017). Assessing an organization's environmental performance is typically conducted poorly due to a lack of awareness about the factors that contribute to its degradation (Kienberger & Zeil, 2014). The environmental dimension of an organization's sustainability program is also important to consider as it provides insight into long-term changes and how they affect the environment. Cappuyns, Vandenbulcke, & Ceulemans (2015) note the various factors that affect an organization's environmental sustainability are energy consumption, water, and emission of greenhouse gases.

### **1.1 Financial Performance**

Kenton, Scott, & Courage (2021) define a company's fiscal performance as the amount of cash it has made after all of its resources have been used. A company's financial performance is a key metric to assess an organization's overall success. According to the Central Bank of Kenya (2016), the three measures used to calculate bank performance are net interest margins, return on assets, and equity. In 2018, IFRS 9 became effective, forcing the banking sector to include non-performing debt provisions in their financial disclosures (IFRS, 2018). A bank must consider the various risks associated with its operations before preparing a financial statement (IFRS Foundation, 2021).

The return on assets is a measure used to assess a firm's financial performance. It shows how quickly and effectively it can generate profits from its assets. A company with a low Return on assets tends to have fewer assets in generating returns. On the other hand, a company with a high Return on assets tends to have more assets in generating returns (Investopedia, 2021). Return on equity (ROE) is a metric of a firm's financial health. It shows how well it manages its funds (Investopedia, 2019). It is an important metric for evaluating a company's financial health based on the shareholder's interest as a higher return on equity is crucial for investors because it demonstrates that the companies are effectively managing their resources (Investopedia, 2021).

The net interest margin refers to the gap between the interest rates that commercial banks and other financial institutions charge on deposits and loans (Kumar R., 2014). The bank's investing operations are inefficient if the net interest margin is negative. A positive net interest margin, on the other hand, indicates that the bank is efficiently utilizing its resources (BLOOMENTHAL, 2021). The net interest income margin rises in direct proportion to the interest rate. Kenya's central bank regularly inspects commercial banks' performance to ensure the safety of their clients' funds (Central Bank of Kenya, 2021). Messai & Jouini (2013) note that unemployment and return on assets are two factors that lead to increased non-performing loans.

### **1.2 Sustainability Reporting**

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## 2. Statement of the Problem

The performance of companies in terms of environmental, social and governance (ESG) factors is crucial for the overall well-being of the economy. It is essential for banks to fully understand the associated risks in order to make well-informed decisions for the nation. However, numerous challenges persist, impeding the full implementation of ESG performance within the country. First, the lack of a comprehensive policy framework for ESG has made it difficult for banks to develop a clear strategy and prioritize performance areas. Second, the lack of a clear legal framework for ESG has also made it difficult for banks to implement performance management systems that would provide them with the necessary information for making decisions.

According to a report released by KPMG in 2021, about 40% of East Africa's Chief Executive Officers were hesitant to account for their ESG performance due to concerns that it may negatively impact one's companies' performance (KPMG, 2021). The CEO of the Kenya Bankers Association stated that banks face a higher financial risk due to their failure to implement ESG programs. Without addressing the various risks associated with climate change, companies will be unable to respond to the changes in financial commitments (The East African, 2022).

An analysis of the core earnings per share (EPS) of the NSE listed banks show that they have had a consistent pattern of underperformance since 2017. The earning per share index fell from -14% in the first quarter of 2017 to -34% in 2020 and then increased to +136% in 2021. Net interest margins also declined from 8% in 2017 to 7% in 2019. As a percentage of total operating income, non-funded revenue decreased from 74% in 2017 to 35% in 2020 (Cytom, 2021). The ratio of loans to deposits has fallen steadily since 2017. Return on equity has also decreased from 20% in 2017 to 15% in 2020 and then increased marginally to 17% in 2021.

Al Zobi and Al-Dhaimesh (2019) established that disclosing on social, economic, and environmental sustainability dimensions of a firm significantly impacted the returns of Jordan's commercial banks. Due to the importance of these factors, Jordanian banks were more aggressive in disclosing these details. In 2017, a study conducted by Ong, The, and Kasbun noted that disclosing sustainability information can positively affect a company's return on assets. In 2020, Buallay noted that disclosing the details of a company's governance issues does not significantly influence stock market performance in developing countries (Buallay 2020). Therefore, investors must focus on Kenya's commercial banks, some of the country's biggest financial institutions. The study therefore sought to assess the influence of environmental reporting on the Return on Assets of commercial banks listed on the NSE in Kenya.

## 3. Objective of the Study

The main objective of the study was to assess the influence of environmental reporting on the return on assets of commercial banks listed at the Nairobi Securities Exchange, Kenya.

## 4. Literature Review

### 4.1 Theoretical Review

#### 4.1.1 Stakeholder Theory

In 1984, Edward Freeman formulated a theoretical framework that centres on the process by which organizations identify their stakeholders. Stakeholder analysis serves as an instrumental tool in discerning an organization's interests, as delineated by authoritative scholars in this domain (Freeman, 2018). The capacity of an organization to generate value and effectively engage relevant stakeholder groups holds paramount significance for its overall well-being. As posited by Freeman, Harrison, Colle, and Parmar (2010), "stakeholder analysis" entails comprehending the diverse expectations harboured among various constituents within the organization.

This analysis is facilitated by their active involvement in a particular project or program. Stakeholder analysis proves invaluable in examining the interests of diverse groups within an organization while simultaneously taking into account the interests of all parties impacted by a decision.

Parmar, Freeman, Harrison, & Colle (2010) state that a company can have two groups of stakeholder groups: primary and secondary. A primary stakeholder is someone who directly benefits from a business or organisation. The other stakeholder group comprises individuals or groups that can have major control over a firm's decisions.

According to this theory, having a well-defined and organized stakeholder base is beneficial for businesses. It can help them maintain and improve their relationships with their customers and other key stakeholders (Revista Brasileira, 2015). A well-defined and organized stakeholder management strategy is also important for a company, as it can help them manage their various stakeholder groups. This process involves conducting stakeholder assessments and creating strategies for stakeholder participation while also developing value-generation tactics (Wicks, Harrison, & Freeman, 2007).

In Sweden, this theory was used to determine the correlation between performance in financial terms and sustainability reporting (Bäckström & Karlsson, 2015). Asuquo, Temitayo, and Onyeogazari (2018) conducted a study in Nigeria spanning from 2012 to 2016, using the aforementioned theory to explore the correlation between "sustainability reporting and financial performance" in publicly traded brewing companies within the country. The concept of sustainability asserts that a business's success is contingent upon the value added to its stakeholders (Maher & Andersson, 2015).

#### **4.1.2 Agency Theory**

Ross (1973) introduced agency theory, which explains that managers are appointed by owners to act on their behalf and fulfil their responsibilities. He also noted that there are often conflicts between the goals of the owner and the agent when it comes to business strategy. For instance, managers tend to focus on short-term goals, while proprietors are more focused on the firm's objectives in the long run. The proprietors and the managers have a principal-agent relationship. This concept gained widespread attention due to the scandals that occurred in the US, such as the Enron case (Pai & Tolleson, 2015). When a company's management has a conflict of interest due to their exceptional knowledge of the business, the conflict is reduced through the sharing of sustainability reports.

Within agency theory, Leepsa and Panda presented two models in 2017: the positivist model and the principal-agent model, which highlight key distinction. Unlike risk-averse agents, principal agents are focused on making a profit. The implementation of ESRP standards has helped resolve and analyze environmental decisions due to the increasing importance of environmental issues for businesses (Cortese, Abeysekera, & Lu, 2015). According to a survey, most large business owners would rather evaluate their management's performance than the environment.

An external director is an individual who assumes the role of monitoring and evaluating the financial performance of an organization (Desender & Epure, 2015). Aside from being responsible for overseeing the financial performance of an organization, external directors also serve as a watchdog for shareholders. Having a board of directors helps organizations avoid potential issues and improve their long-term performance (Villiers, Naiker, & Van Staden, 2011). Apart from supporting the organization in pursuing its short-term and long-term objectives, sustainability disclosure can also mitigate the impact of agency conflicts (Ntim, Lindop, & Thomas, 2013).

#### **4.1.3 Signaling Theory**

According to Karaman, Kilic, and Uyah (2020), organizations frequently emit signals that enhance communication quality and minimize knowledge asymmetry among stakeholders and employees. Information asymmetry, on the other hand, refers to administration's attempt to gain and publish knowledge to acquire control over the marketplace and its components. The signaling concept considers various components of a communication system, including the signaler, the receiver, and the feedback. The decisions made by the sender and receiver regarding the data and signals transmitted are crucial when receiving and interpreting the information. Executives, managers, and employees typically receive these signals and have exclusive access to the organization's data (Taj, 2016).

According to the signaling concept, entities are willing to pay a premium to obtain specific information. Therefore, signaling is a process that organizations use to communicate their goals and actions. There are three types of signaling that organizations can employ: signals that indicate future actions and requirements, and signals that conceal potential liability issues (Connolly, Certo, Ireland, & Reutzel, 2010). Signaling principles are utilized in various managerial disciplines such as finance, marketing, and human resource management to communicate goals and actions. The concept of signaling has gained widespread acceptance in environmental practices due to its ability to detect business signals, which have become increasingly important in managerial communication.

### **4.2 Empirical Review**

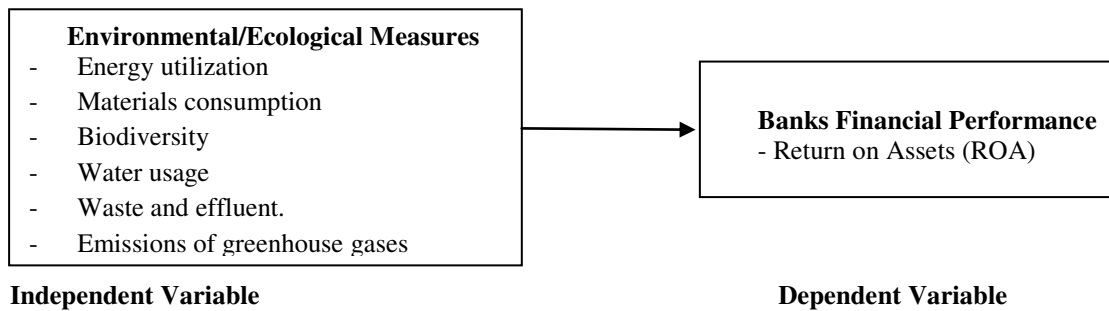
#### **4.2.1 Environmental Reporting and Financial Performance**

Osman, Ikkal, and Hashim (2021) explored the impact of sustainable reporting on financial results in three Arab countries. The research's objective was to find a linkage between the various sustainability metrics and financial performance. The study took place in Oman, Jordan, and the UAE. The fiscal reports plus sustainability reports of the banks were analyzed, and the study results revealed a positive impact of social and environmental factors on fiscal performance, which could be associated to the country's banks. The positive influence of ecological factors on fiscal performance was also noticed in Oman. However, the fiscal performance of Jordanian banks was negatively impacted by the country's environmental issues, resulting in a negative correlation between sustainability reporting and fiscal performance. In short, the study results revealed that the positive impact of environmental and social factors on fiscal performance could be attributed to the country's banks.

Zyadat (2016) investigated the financial performance of Jordanian Islamic banks considering sustainability reporting standards. The research reviewed the fiscal performance of Jordan's Islamic banks from 2008 to 2014. Several financial criteria were examined, including return on capital, assets, and earnings per share (EPS). Representatives from Jordan's two main Islamic financial institutions conducted the investigation. Jordan's Islamic banks' financial statements and yearly reports were scrutinized for accuracy. The study showed a negative connection between ecological sustainability and fiscal performance in Islamic banks. The researcher suggested that more research be conducted on how other elements not included in the research study affect sustainability reporting. Furthermore, additional training should be provided to banking staff for them to improve their sustainability reporting.

### 4.3 Conceptual Framework

The study developed a conceptual framework to illustrate the relationship between the variables as indicated in Figure 1.



## 5. Research Design

A descriptive research design was chosen for this study because it not only focused on collecting and describing the data, but also aimed to investigate and determine the relationships among the variables being studied. The target population, for this study consisted of 23,734 employees (Central Bank of Kenya, 2023) from 11 banks listed in the Nairobi Securities Exchange (Cytonn, 2022). The study used Yamane (1967) formula to generate 378 respondents who were selected using a stratified random sampling technique involving management, Supervisory, Clerical, and Secretarial. The study also implemented a simple random sampling method to select the sample from every section (Cooper & Schindler, 2017).

Questionnaires were employed to collect primary data, whereas data collection sheets were used to gather secondary data. The survey utilized a five-point Likert scale in order to collect participants' perspectives on the constructs. The research used panel data from four years, from 2017 to 2021. This period was chosen due to the firms' availability of sustainability disclosures in their reports. Data was collected on net assets, profits, ROE, and ROA. The researcher received an introductory letter from the university, which was subsequently distributed to each respondent to obtain their consent for data collection. A visit was conducted to the selected banks in order to formally request permission to gather data from their staff. The drop-and-pick method was used to distribute questionnaires. The researcher conducted a pilot study with a total of 38 bank staff members to evaluate the validity and reliability of the data obtained from the questionnaire. This study employed content and construct validity where Average Variance Explained (AVE) was used in determining construct validity with a cut-off value of 0.5, as recommended by Sallis, Gripsrud, Olsson, and Silkoset (2021). Cronbach's alpha was used to assess reliability (Cooper & Schindler, 2012) with a threshold of 0.7 for the Cronbach's Alpha Coefficient. Both descriptive and inferential statistics were used to analyse the data in SPSS encompassing techniques such as frequencies, means, and percentages while inferential statistics utilized in this study consisted of correlation and regression. The researcher took all necessary precautions to safeguard the collected information from unauthorized access and misuse. The data was obtained from individuals who had legal permission to participate in the research.

## 6. Findings

### 6.1 Response Rate

The study response rate was 71.5%. The high response rate was attained through meticulous adherence to the data collection procedure and sustained communication with the participants encompassed within the sample.

**6.2 Descriptive Statistics on Environmental Reporting**

The study collected primary data using a Likert scale questionnaire with rating indicated in the key: 1- strongly disagree (SD), 2- disagree (D), 3-Neutral (N), 4-agree (A), 5-strongly agree (SA). The results were presented in Table 1

**Table 1 Environmental Reporting**

Statements	SD		D		N		A		SA		M
	F	%	F	%	F	%	F	%	F	%	
The materials used in the production of various products are made from recycled materials.	8	3.3	51	21.0	10	4.0	37	15.2	137	56.4	4.07
Energy usage from a single primary source.	135	55.6	43	17.7	18	7.4	28	11.5	19	7.8	1.98
Energy saved as a direct consequence of conservation programs and efficiency enhancements.	35	14.4	8	3.3	26	10.7	83	34.2	91	37.4	3.77
Initiatives aimed to provide energy-efficient products and services and reduce the energy requirements of their users.	27	11.1	27	11.1	20	8.2	61	25.1	108	44.4	2.00
Various initiatives are carried out to reduce energy consumption.	26	10.7	17	7.0	9	3.7	91	37.4	100	41.2	3.91
Water withdrawals totalled by source.	8	3.3	20	8.0	26	10.7	101	37.4	88	36.2	3.59
Various initiatives that aim to reduce greenhouse gas emissions.	17	7.0	17	7.0	18	7.4	37	15.2	154	63.4	4.21
Efforts to mitigate the ecological consequences of a variety of products.	18	7.4	8	3.3	8	3.3	83	34.2	126	51.9	4.20
There is high number of products sold and made from recycled materials.	109	44.9	64	26.3	26	10.7	8	3.3	36	14.8	1.43

Source: Research (2023)

From Table 1, the majority of the staff strongly agree (m=4.21) that there are several initiatives in place to reduce greenhouse gas emissions. The staff also agree that efforts are being made to mitigate the ecological consequences of a variety of products (m=4.20) and that the materials used in the production of various products are made from recycled materials (m=4.07). Various initiatives are also carried out to reduce energy consumption (m=3.91), and energy is saved as a direct consequence of conservation programs and efficiency enhancements (m=3.77). Water withdrawals are totalled by source (m=3.59). However, the staff disagrees that initiatives are aimed at providing energy-efficient products and services and reducing the energy requirements of their users (m=2.00), as well as energy usage from a single primary source (m=1.98). Some staff strongly disagree that there is a high number of products sold and made from reclaimed materials (m=1.43).

Findings imply that the banks observe environmental responsibility. This is achieved through the implementation of various initiatives to reduce greenhouse emissions, mitigate the ecological consequences of products, use products made from recycled materials, and initiatives to reduce energy consumption. However, these initiatives are not enough, as the banks are not yet able to reduce the energy requirements of their users. The banks also use energy from different sources, meaning that they have not fully implemented environmentally friendly energy sources. Even though the banks have made efforts to use reusable materials, a high number of products are not yet made from reclaimed materials.

**6.3 Correlation Analysis**

The study used Pearson Correlation to evaluate the association between financial performance of Kenyan commercial banks listed on the NSE and sustainability reporting. Table 2 presents the correlation analysis's results.

**Table 2 Correlation Coefficients**

Variables		Financial Performance	Environmental
Financial Performance	Pearson Correlation	1	
	Sig. (2-tailed)		
Environmental	Pearson Correlation	.605**	1
	Sig. (2-tailed)	.000	

\*\* . Correlation is significant at the 0.05 level (2-tailed)

Source: Research (2023)

The findings demonstrated in Table 2 showed a strong and significant correlation ( $r = 0.605$ ,  $p$ -value = 0.000) between environmental reporting and financial performance. As a result, the study rejects the null hypothesis because statistical evidence suggests that environmental reporting has a key effect on NSE listed banks' performance. This result runs counter to Zyadat (2016) findings, who found a negative connection between environmental sustainability and financial performance in banks.

#### 6.4 Regression Analysis

The effect of sustainability reporting programs on the financial performance of commercial banks listed on the Nairobi Securities Exchange in Kenya was explored using regression analysis. The results are shown in Table 3.

**Table 3 Regression Coefficients**

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
Constant/Y Intercept	1.412	.340		4.155	.000
Environmental	1.195	.101	1.110	11.829	.000

The findings in Table 3 indicate that the anticipated financial performance of the commercial banks listed on the Nairobi Securities Exchange (NSE) in Kenya is projected to be 1.412, under the assumption that all variables remain constant and are set at zero. An increase of one unit in environmental responsibility is linked to a substantial increase in financial performance, amounting to 1.195.

#### 7. Conclusion and Recommendation

In line with objective one, there exists a robust and statistically notable association between the disclosure of environmental information and the financial effectiveness of an organization. Moreover, the findings disclose that implementation of various initiatives aimed at curtailing greenhouse gas emissions, mitigating ecological impacts caused by diverse products, utilizing recycled materials in product manufacturing, adopting measures to diminish energy consumption, realizing energy savings through conservation programs and efficiency enhancements, as well as monitoring water withdrawals by their respective sources. Additionally, efforts are being made to promote energy-efficient products and services and minimize energy requirements for end users. It should be noted that energy consumption is not reliant on a single primary source, and the utilization of reclaimed materials in product manufacturing remains low.

The banks should strive to provide energy-efficient products and services to reduce energy consumption for their customers. Additionally, they should prioritize clean energy sources as their primary energy supply. This can be achieved by installing solar panels and redesigning office spaces to maximize natural lighting, thereby reducing the need for artificial lighting during working hours. Furthermore, the banks should increase the use of recycled materials in their products, which will not only cut down procurement costs but also contribute to better environmental reporting.

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