

Mandatory and Discretionary Non- financial Disclosure After the European Directive 2014/95/EU

**An empirical analysis
of Italian listed
companies' behavior**

Francesco De Luca



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United Kingdom – North America – Japan – India – Malaysia – China

Emerald Publishing Limited
Howard House, Wagon Lane, Bingley BD16 1WA, UK

First edition 2020

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British Library Cataloguing in Publication Data

A catalogue record for this book is available from the British Library

ISBN: 978-1-83982-505-7 (Print)

ISBN: 978-1-83982-504-0 (Online)

ISBN: 978-1-83982-506-4 (Epub)



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Acknowledgment

The author would like to thank the peer reviewers for their fruitful comments.

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Introduction

The present economic context is witnessing a progressive decrease of trust. Society distrusts institutions and companies as it is difficult to find out which companies are trustworthy in offering goods and services in compliance with a certain standard of quality. People find it difficult to understand if companies and institutions are acting consistently with the interest of the community. Moreover, media are more often negative news about large corporate groups as protagonists. It is easy to recall the recent Volkswagen scandal as a striking example; in the same vein, even with different facets, we can remember of accusations made against the mobile phone company Huawei, along with the Cambridge Analytica accusations and the Foxconn suicides. It appears quite clear that these companies have several things in common, namely and mainly the high profits they register annually as well as a rather questionable behavior they put in place for the exercise of their economic activity.

The negative impacts on the climate following the high CO₂ emissions, the violation of users' privacy, and corruption and exploitation of workers aimed at increasing profits are just some examples of the negative actions taken by several companies. These behaviors can go further at least until consumers and the community in general no longer place trust in those companies. Of course, this fall of trust could be the triggering point of unfavorable situations which in most cases lead to negative impacts on performance and further serious consequences such as the dissolution of companies.

This is the main reason why academics, practitioners, regulators, and users of companies' information have always considered *transparency* in corporate communications as an infallible value. Moreover, transparency has been pursued and claimed traditionally for financial information and, since the last decades, it has been extended to non-financial information (NFI) and its accountability in supporting the users' decision process (ICAEW, 2016; Lai, Melloni, & Stacchezzini, 2018). Boundaries between the former and the latter have been defined and redefined (Girella, Abela, & Ferrari, 2018). In this context, standard setters and regulators play an important role in encouraging (or mandating) firms to provide more useful and transparent information. In fact, the public dissemination of companies' prospectuses expressly focused on NFI constitutes a valid instrument with which companies relate to the vast audience of stakeholders. Moreover, the growing interest in the explicit reference to ethics and social responsibility issues has led to a significant evolution and implementation of reporting models.

There have been numerous initiatives which started to build the theoretical background behind the possible approaches to guide the non-financial reporting. Various international organizations have been established, such as the International Integrated Reporting Council (IIRC) and the Global Reporting Initiative (GRI), among others. These institutions have proposed specific guidelines and frameworks with the aim of providing standards to follow in addressing companies' NFI consistently with users' needs.

In this context, the doctrinal and professional debate has also been addressed on the *voluntary vis-à-vis mandatory* feature of NFI reporting. In Europe, the EU Directive no. 2014/95 of October 22, 2014, amending Directive 2013/34 EU, has represented an important shift from the regulator perspective as it is the first attempt to settle a mandated content for European-based companies with specific reference to NFI. According to this directive, large undertakings and groups are mandated to draft a report (that could be separate as well as included in the annual report) to communicate their commitment and policies on specific topics such as the environmental and climate protection, the employee protection and management of staff, respect for diversity, the fight against corruption, and the fight against the violation of human rights.

With this work we intend to investigate the companies' behavior in preparing NFI disclosure in the aftermath of the new directive issuance, with specific reference to the evolution of reporting tools and the frameworks proposed by international organizations to outline homogeneous standards for comparability purposes. Considering the shift from voluntary to mandated information, special attention will also be given to the problem of managerial discretion that could occur when managers act for their own interests rather than those pursued by companies and community (Fiandrino, 2019). Moreover, EU Directive 2014/95 has been implemented in all EU member states with laws country specific. Anyway, considering that the directive settled a basic blueprint, at the European level there are not significant differences in the adoption of the above directive across countries.

With reference to the topic of NFI, generally, extant literature does not find unanimous agreement on the potential benefits deriving from more or improved regulation (Chauvey, Giordano-Spring, Choand, & Patten, 2015; Costa & Agostini, 2016; Venturelli, Caputo, Cosma, Leopizzi, & Pizzi, 2017). Therefore, more research is required, especially if we consider the push for authorities to regulate more and more the requirements for companies about NFI disclosure in response to stakeholders' expectations.

However, the transposition of the EU Directive into the national legal systems raised skepticism among academics and practitioners regarding its real impact. In fact, the absence of a specific content, a definitive method of reporting, a valid enforcement system for the provision of NFI, and the coexistence of voluntary and mandatory items in the EU Directive pushed toward a limited influence on NFI reporting (Farneti, De Villiers, & Dumay, 2018). Moreover, the above Directive requires to large undertakings and public interest entities (PIEs) to provide a specific disclosure about social, environmental, employee, respect for human rights, anti-corruption and bribery matters. Furthermore, the NFI should

disclose the business model, the policies related to those issues, the main risks involved in them, and the outcome of those policies. In this regard, recent contributions have tried to assess the level of compliance to the new requirements (Fiandrino, 2019; Venturelli et al., 2017). However, there is not a unanimous assessment about the impact of this new information package on the company performance.

To this end, we intend to address the research question whereas improved regulation and mandated NFI disclosure could affect, and eventually improve, companies' economic performance.

Therefore, in order to provide empirical support to the above research question, we opted for analyzing Italian context where the directive has been adopted with the legislative Decree no. 254/2016 valid for the fiscal year 2017. Through this analysis, we aim to provide an up-to-date portrait of how companies mandated to adopt the new regulation have (or have not) experienced an improvement of their economic performance.

To address this research aim, the book is based on the Italian context firstly because there are evidences of the importance that CSR reporting assumed in Italy (KPMG, 2013; Rossi & Tarquinio, 2017). Secondly, the mandatory disclosure of NFI in Italy is more stringent than the EU directive as it has been adopted with the Italian Decree no. 254/2016 which introduced a cogent system of external controls, imposing the assurance of the disclosure and a sanctioning regime for directors, required to draft and publish non-financial declarations and supervisory bodies, called to control them. At the same time the Italian legislator has provided for a wide range of methods of reporting NFI, with the possibility of also using an autonomous reporting methodology and of voluntarily disclosing NFI for SMEs, with less burdens than those the larger companies are obliged to bear (Muserra, Papa, & Grimaldi, 2019).

The study makes an original contribution as it is one of the pioneering studies investigating the mandatory disclosure on NF risks in the Italian context in the aftermath of the new regulation. Specifically, this study extends the prior literature by addressing the informativeness of the Italian financial market NFI disclosures. In fact, in the aftermath of the above Decree, it is worth understanding to what extent companies disclose NFI and if the firms have different behavior in disclosing this information depending on the industry, size, and governance variables. This study could also be useful in the policymakers' perspective, by providing guidance on the various differences between NFI reporting approaches.

In addition, our results could help managers and investors with regard to the reporting and identification of information considered critical for maximizing company value. Furthermore, these first results could help companies to follow the best practices and to adopt approach able to face the trade-off between being transparent or secretive, and they also could help companies not obliged to NF disclosure to understand the relevance to disclose (and manage) NF information.

As for the policy implications of the study, since the improvement of company disclosure of social and environmental information (including information about risk) represents one of the eight areas in which EU policy has put forward an action agenda, our results could represent relevant evidence for European

policymakers of the action agenda in a twofold way: improving the convergence between European Policies and the global approach to NF disclosure, and improving the company disclosure and, in turn, management of companies' non-financial risks.

The remainder of this book proceeds as follows. Chapter 1 will provide an introduction to the evolution of corporate communication models and about how these are shaped according to the stakeholder theory, whether financial or non-financial. In fact, the evolution of the number and the quality of stakeholders has forced companies to prepare additional information to meet the various information needs, where financial information has been considered a starting point to provide NFI, originally on a voluntary base and more recently as a necessity to comply with law.

Chapter 2, as a consequence, is devoted to the review of the doctrinal debate about voluntary information, and how it constitutes a valid support for the creation of added value. This last condition has been deemed to have contributed over the years to the evolution of the relevance of issues as social responsibility, business ethics, and sustainability. Besides, the increasing use of companies' sustainability reporting tools has prompted international bodies, mainly IIRC and GRI, to promote guidelines on how such disclosures should be carried out. In this context, with the above directive, Europe played a pioneering role, by mandating all listed companies and PIEs to disclose their non-financial information concerning the protection of the environment, the management and defense of employees, the fight against corruption, and the protection of diversity and human rights.

Then, Chapter 3 is focused on the debate about the management discretion in providing NFI and incentives to do so. In fact, the possibility of different and conflicting interests between managers and organizations may affect the typology, the extensiveness, and the quality of NFI resulting in information asymmetry, "window dressing" information, and other negative consequences.

Lastly, in Chapter 4 an empirical analysis is introduced, to assess the possible influence of NFI on the market performances of companies listed on the Milan Stock Exchange (Italy). The main purpose of this analysis is to observe whether in the aftermath of the new regulation there are some appreciable benefits as recognized by the market performance or, on the contrary, positive effect could only be expected on the long run.

Chapter 1

Corporate Information

1.1 Corporate Accounting Information System

With the term “corporate information,” we indicate the representation that the internal and external subjects provide of the business facts. This information is fundamental as it constitutes the premise every decisional process is based upon (Melis, 2008).

The informative system plays a fundamental role for the company, since it informs and controls the operational system, in such a way that it acts rationally in compliance with the principle of economic equilibrium.

The information flow generated varies according to the need of the various decision-making centers. Generally, correct information must possess characteristics, such as dependence – that is, not internally flawed, synthetic, and abstracted by complex phenomena – and frequent, in a well-defined and presentable time horizon, both with qualitative and quantitative contents.

The correct use of information both in terms of internal decision-making processes and external communication presupposes requirements that can be identified in selectivity, flexibility in shaping changes, reliability, acceptability, integration, timeliness, and convenience expressed in terms of cost–benefit ratio (Paolone, 2012).

Since the company is an open system, which interacts with the external environment, financial information constitutes a key point of the relationship firstly with the subjects that bring capitals who appear to be the residual claimants of the company’s created value.

In the relationship with these subjects, the company places reports of different utility, in addition to the mandatory ones, concerning the relationships it has with debtors and creditors, the prices of goods and procurement policies, the asset transactions, the environmental initiatives aimed at providing a favorable image toward the community, and others.

From this point of view, information belonging to the non-financial information (NFI) disclosure is useful to communicate the relationship with the environment, with the employees, and with the community in general, to acquire the consent of third parties. It follows that the greater the willingness to

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communicate these objectives outside, the higher the amount of information the company will provide.

On the other hand, concerning the information process intended for internal parties, it is necessary to specify that the information is transmitted through the reporting, which is a valid means for evaluating the performances achieved and the future targets through the use of performance management system and specific indicators that have the purpose of assessing the level of competitive advantage of the company.

The company informative process flows should follow predefined phases such as (Candiotta, 2016):

- collection,
- processing, and
- transmission.

Collected data can derive from the outside, in relation to the environment, to macroeconomic forces, to socio-political, etc., variables, as well as from within, that is, strategic planning, control, and individual areas.

Once the collection phase is complete, the data are selected and classified to obtain a simplification of the reality that will constitute the starting model for the next phase, i.e., the processing phase.

Through the processing phase, the data are refined according to the various decision-making centers for which they are addressed and must possess the characteristic of usefulness, i.e., they must be able to provide useful information for the users' needs and they must be timely available.

If the information is intended for operational decision-making levels, the information must be analytical; if instead it is intended for management decision-making levels then the information must provide actual and prospective data that could be useful for long-term planning.

With the transmission of information, the recipients can access the final information. Further to this point, it is necessary to specify that the transmission is characterized by three elements: the contents, the channels, and the procedures.

The content internal to the information flows depends on the relationship established between the bodies set up to refine and process the information and the recipient centers, such that information needs will differ across different recipients.

This will also have an impact on the communication channels and the procedures that include the methods and timing of reporting among various corporate bodies.

The strategic planning system is one of the most influenced fields by the corporate information system since the choices regarding the actions to be implemented are affected by the inside information, which allows the planning activity.

Given the interaction with other disciplines related to business administration and management, over the years, the information system has undergone a deep and wide upgrade in terms of tools and methods intending to meet the evolving

needs of the stakeholders. This has progressively led to extend the accounting information range to a wider extent that could encompass also qualitative elements, rather than the mere quantitative ones, to improve the quality of internal and especially external information (Salvatore, 2013).

This has led to the need to report all the events that, directly or indirectly, can be traced back to the behavior of the company and to the relationships with third parties through suitable instruments. This has also led to a regulatory evolution in the field of reporting, especially in the direction of NFI and integrated reporting as a new concept about the functions and uses of traditional reports. In this sense, we observed several pushes both from academics and practitioners toward the encouragement of companies to consider the implementation of integrated reporting systems by adding social and environmental information through providing a wider and more general view of the company.

1.2 Corporate Financial Information

In general, financial information represents the ability of the company to process and communicate information in a structured and effective way, historical and perspective, qualitative and quantitative, representative of their *raison d'être*, of their strategic orientations, of their performances, and of their economic, financial, and patrimonial balance (Bartoli, 2006).

Financial information has the purpose of assessing the propensity of the company to reach the condition of economic and financial equilibrium while respecting the strategic and social policies. This evaluation influences the judgment of the stakeholders about starting/maintaining/ceasing relationships of different nature with the company.

The subject of corporate economic-financial information has been extensively dealt with in the corporate literature, with different interpretations and approaches.

A first position attributes a division between mandatory and voluntary information.

A second interpretation highlights the distinction between economic communication and financial communication.

Economic communication has a prospective content of a patrimonial nature used for management purposes in order to obtain trust from the company interlocutors and, at the same time, a positive judgment from the market. Given the number of stakeholders, the process of economic communication must be used with caution as the loss of credibility would lead to a worsening of the performance that would affect the reduction of the corporate image.

Financial communication, on the other hand, is subject to the capital market to which the company turns to obtain capital to be reinvested in the production process or to reinvest surplus liquidity. This communication aims to inform potential investors about the risks or benefits deriving from a possible investment choice, supporting the decision-making process regarding the possible investment alternatives (Giacosa, 2015).

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Although the doctrine identifies a different interpretation of economic and financial information, in practice, with economic-financial communication we mean the set of items, qualitative and quantitative, which have strategic value, internal and external, and based on principles of transparency, correctness, and truthfulness.

The economic-financial communication can have a different nature depending on the degree and nature of the information, as follows:

- (1) *mandatory communication*: originating from the fulfillment of laws requirements and regulations having the force of law, to protect the needs of corporate stakeholders, through the financial statements, usually composed of the Balance Sheet, Income Statement, Cash flow statement, and notes.
- (2) *voluntary communication*: of a nonmandatory nature but which falls within the primary communication as well as the mandatory one, intending to increase the quality and quantity of information to obtain consent from stakeholders. This kind of information is often considered as an intangible value since it does not derive from legal obligations and it exceeds the discretionary limit imposed by the law. Moreover, it can concern business aspects that are not detected by the mandatory disclosure, but which may have strategic relevance and a definite impact on performance.
- (3) *derived communication*: considered as secondary information as it is generated through the control activity (auditing) on the information within the mandatory and voluntary disclosure. This auditing activity is made by subjects outside the corporate management (auditing firms, institutional investors, rating agencies, analysts, etc.) with the purpose of providing information filtered based on the cognitive need of the various categories of stakeholders (Branciari, 2004). Derived communication also has an immaterial value as, unlike the primary disclosure, it can be used as a means to compare different companies.

Basing on the characteristics of the recipients, the economic-financial information can be differentiated into:

- (1) *Internal reporting*: intended for subjects within the company as a support to the planning and control processes to monitor economic convenience (Pao-lone & D'Amico, 2017).
- (2) *External reporting*: intended for subjects external to the company, such as suppliers, customers, consumers, financiers, trade unions, and the State, transmitted to ensure greater openness of the company toward the external environment through the establishment of solid and collaborative relationships. The objective is to declare the corporate identity through periodic information, promoting commercial development to create consensus and facilitate the procurement process (Giacosa, 2015).

While internal communication is carried out through the analysis of information flows, of the organizational climate, the image that employees have of the company, and relations with colleagues and with the various management areas,

external communication focuses on how the external environment perceives the corporate image, and on the communication process through which to disseminate production methods, the range offered, environmental impact, sustainability, and all those factors that can have a positive impact on the corporate image.

1.3 The Stakeholder Theory

As previously illustrated, economic-financial communication differs according to the characteristics of the recipients of information and the number and the diversification of the stakeholders.

A stakeholder is defined any individual who has an interest in the company's decisions or is able to influence its current or potential success (Fossati, Luoni, & Tettamanzi, 2009).

The term was firstly used by the Stanford Research Institute (SRI) in 1963 although the first hints were already given with Smith (1759), Berle and Means (1932), Barnard (1938), and March and Simon (1958).

Later, in the 1980s, thanks to the contribution of Freeman (1984), the concept of stakeholder led to the articulation of the stakeholder theory according to which managers that are able to understand the needs of stakeholders can use them as a strategic tool.

The assumptions of stakeholder theory can be summarized in the following four key points:

- (1) the company is an agglomeration of stakeholders interacting with each other;
- (2) the decisions must consider not only the shareholders that hold shares of the company but all the stakeholders;
- (3) a prerequisite for sustainability with a view to creating value;
- (4) achieving the economic goal presupposes ethics.

Stakeholders are all those who bring a specific interest in the company, namely: employees, collaborators, suppliers, customers, shareholders, local communities, competitors, institutions, public institutions, trade unions, and research institutions which they can influence or be influenced by company objectives (Fig. 1).

Depending on the degree and relationships they establish with the company, they may have different needs and informational prerogatives, as they may or may not influence the company's performance, the strategies and policies it pursues, and the final objectives.

Although the Freeman framework turns out to be the most complete about the definition of stakeholders, there have been many contributions, even recent, from scholars who have tried to provide a homogeneous definition applicable to all contexts of the term "stakeholder".

In this regard, the work of Mitchell, Agle, and Wood (1997), which provides a literary analysis of the most important definitions that the researchers attributed to the concept of stakeholders, cannot fail to be mentioned.

This study, among others, cites the definition by Clarkson (1995), according to which there can be two types of stakeholders: primary and secondary. This

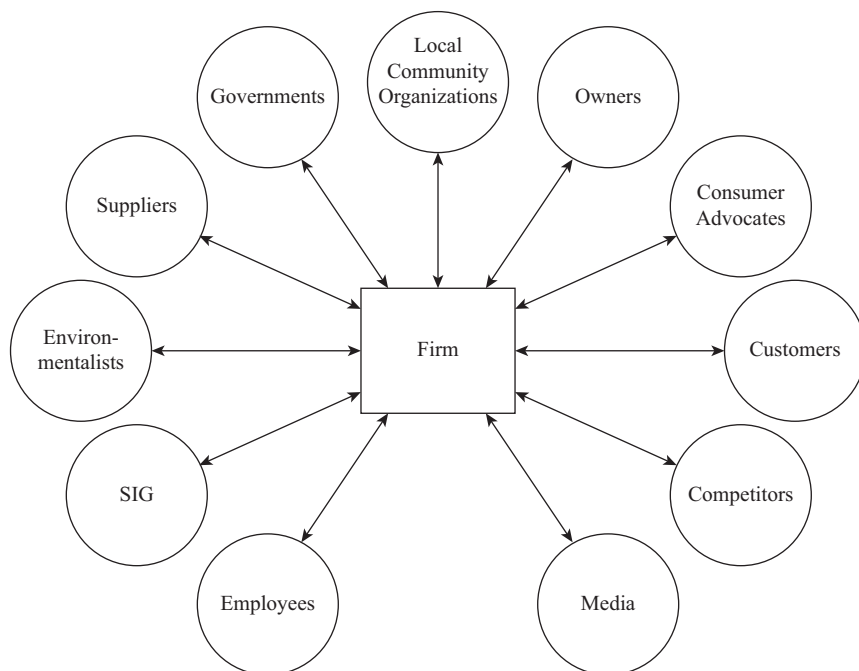


Fig. 1. Stakeholders of the Company (Freeman, 1984, p. 25).

framework does not only constitute a mere classification among the type of stakeholder because it highlights that it is in the nature of every company having a different relationship with stakeholders, and this may depend on several factors, including the strategic orientation.

The primary stakeholders (shareholders, investors, employees, customers, suppliers, governments, and the community) are those subjects without which there is no survival of the company, such that the principle going concern is lost.

Secondary stakeholders (media and interest groups), on the other hand, are not essential about company survival while influencing the internal and external dynamics of the latter.

Therefore, the company cannot satisfy the needs of all categories of stakeholders, as it can pay attention to particular groups.

According to Mitchell et al. (1997), it is necessary to legitimize the relationship between the management and the stakeholders avoiding a too wide appropriation of power by the latter, which can alter the normal activities of the company, for which it is necessary to establish the degree of the relationship based on:

- Stakeholder power;
- Legitimation of the relationship;
- Urgency of stakeholder demand.

The combination of these variables can lead to the selection of different stakeholders with a different relationship with the corporate entity, depending on the three attributes they can take; they are (Fig. 2):

- (1) *power*: a subject exercises power thanks to the help of three resources:
 - *coercive* power, based on physical resources of strength, violence, and moderation;
 - *opportunistic* power, based on financial and/or material resources;
 - *regulatory* power, based on symbolic resources;
- (2) *legitimacy*: it depends not only on a perception of oneself in a superior position with respect to a counterpart but also as a broader good;
- (3) *urgency*: it is based on:
 - *criticality*, that identifies the degree of expectation of the stakeholders, so that a higher degree requires immediate attention from the management;
 - *sensitivity*, that presupposes a maximum limit within which the management must respond, as any overcoming of will not be acceptable by the stakeholders.

Fig. 2 highlights the different identification of stakeholders according to the attribute considered so that they can be grouped into three different categories: (1) latent stakeholders, (2) stakeholders with expectations, and (3) definitive stakeholders.

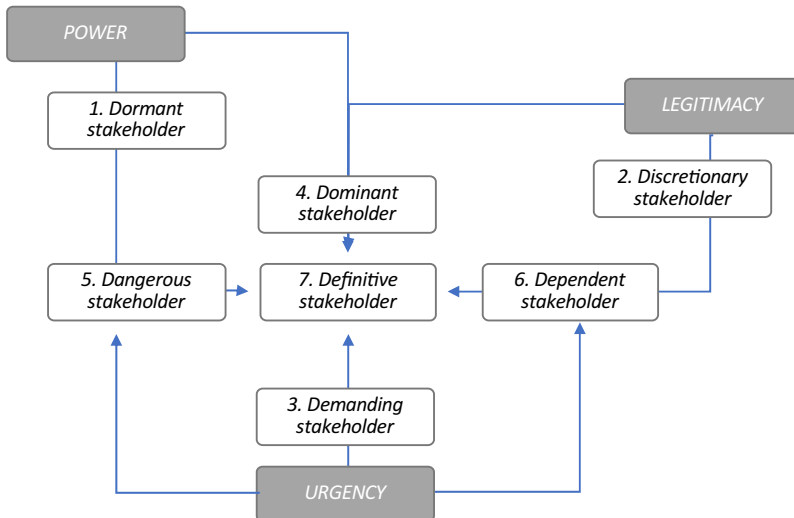


Fig. 2. The Combination of Variables for Stakeholders' Categorization. *Source:* Our adaptation from Mitchell et al. (1997, p. 874).

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Latent stakeholders are identified only by one of the main attributes (Power - Legitimacy - Urgency).

This category includes dormant stakeholders (1), who can impose their interests on the company using power. The management does not give them any relevance even though they could become more demanding when they acquire urgency or legitimacy: an example of this category is made up of former employees.

Another subcategory of latent stakeholders is the discretionary stakeholders (2): their relevant attribute is legitimacy, although they have neither power nor urgency, so they have no pressure on management that could be considered a type of prevalent stakeholder.

It appears to be an important category from the standpoint of studies on corporate social responsibility, and among those belonging to this category are nonprofit entities, schools, hospitals, etc.

The last subcategory belonging to that of the latent stakeholders is given by the *demanding* stakeholders (3) who are in urgent need, resulting in hindrances for the management: as not having either power or legitimacy, they only want the attention of the managers without being able to lead to the next step the relationship with the company. This category can be represented by the protesters who organize strikes or demonstrations regarding certain themes or actions that the company has taken.

With regard to the stakeholders who have expectations, they differ because they have several main attributes, which – by combining – can take an active position, so the relational degree of relationship with management is higher.

This group includes the dominant stakeholders (4). They have legitimacy and power, so they have a significant influence on the company, and receive attention from managers; and in more structured companies they are part of governance: some examples are given by the Board of Directors, the offices of public relations, and human resources offices.

Dangerous stakeholders (5) are characterized by power and urgency but without legitimacy and can act violently and inadequately both for relations with the management and for the whole environment that has relations with the company. They are all included among those who carry out wild strikes, acts of terrorism, and sabotage.

Finally, the dependent stakeholders (6) have legitimacy and urgency although they have no power: they depend on the stakeholders with a high degree of power or on the management itself.

The last category of stakeholders within the model is given by the definitive stakeholders (7), which are characterized by having power and legitimacy. For this reason, the managers have to immediately deal with the needs arising from this group, and if the management should not correctly address the need of the definitive stakeholders, the company could be negatively affected by their judgment.

In this context, stakeholder theory gives an overall view between the company and its stakeholders to create long-term value.

On the other hand, the intrinsic contribution of this theory is not to provide a justification for opportunistic behavior by certain groups of stakeholders, such as