7th International Scientific Conference
"Business and Management 2012"
May 10-11, 2012, Vilnius, LITHUANIA

ISSN 2029-4441 print / ISSN 2029-929X online
ISBN 978-609-457-116-9 CD
doi:10.3846/bm.2012.085
http://www.bm.vgtu.lt

ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) KEY PERFORMANCE INDICATORS FOR SUSTAINABLE REPORTING

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Abstract. The report is targeted at key environmental, social and corporate governance (ESG) indicators of performance. The performance indicators ESG are becoming more and more important for complex assessment of a company and of unified Sustainable Reporting. The development of key performance indicators is under development in many international institutions, e.g. UNEP, EFFAS, DVFA, CFA etc]. ESG stands for Environmental, Social and Governance. There is growing evidence that suggests that ESG factors, when integrated into investment analysis and decision making, may offer investors potential long-term performance advantages. The aim of this paper is to introduce and give theoretical possibilities of establishing ESG key performance indicators at the corporate level to support investors' decisions and to be a part of Sustainable Reporting. On the basis of theoretical knowledge was made an empirical analysis in small and medium enterprises at the Czech Republic in selected sectors with a focus on the ESG performance indicators and Sustainable Reporting.

Keywords: environmental performamnce, social performance, corporate governance, key performance indicators, sustainable reporting, small and middle companies.

Jel classification: M29, M14, Q56

1. Introduction

The performance is the company's ability to achieve certain results based on given comparable criteria, compared with the results of other companies, which can be expressed in positive values. Performance in conjunction with sustainability is additionally considered as ability to achieve such comprehensive results for much longer time. If we look at the comprehensive performance of the company, it is often defined as the company's ability to show the best results from various possible points of view. But this does not necessarily mean that only the company that shows good financial results has high performance. To measure sustainability of the performance the company can use different methods, tools and approaches which are still under development in the domestic and international institutions; they bear on statutory requirements and on voluntary reports.

Aim of the article and research questions. The aim of this paper is to introduce and give theoretical possibilities of establishing ESG key performance indicators at the corporate level to support investors' decisions and to be a part of Sustainable Reporting. The article is based on solution of the project no. P403/11/2085 *Construction of Methods for Multifactorial Assessment of Company Complex Performance in Selected Sectors* funded by the Grant Agency of the Czech Republic at 2011. Processor of the project is Faculty of Business and Management of Brno University Technology and co-processor is Faculty of Business and Economics of Mendel University in Brno.

Methods used in research. The expected result of the empirical research will be an analysis of economic environmental, social and Corporate Governance aspects Performance Company. Examine, analyze and categorize contemporary characteristics of the individual pillars: economic, environmental, social and corporate governance in relation to the measure of progress or dynamics of development of the overall company performance.

Conclusions. Empirical analysis is oriented in small and medium enterprises in the Czech Republic in the manufacturing, construction, wholesale and retail trade and information and communication technology. The research will focus on the critical partial processes in the fields: Integration of economic performance; Integration of environmental performance; Integration of social performance; Integration of corporate governance.

2. Key performance indicators

Performance Management is a management style, based on evaluation of financial and non-financial indicators, called Key Performance Indicators, which have a comprehensive system design and are fully understood and integrated into enterprise-wide management system with an orientation to the future.

Sustainability Performance Management is a term in the framework of responsible business, now directed to a sustainable business. It focuses on economic, environmental and social aspects of corporate governance in general and in particular with regard to sustainability. It attempts to link environmental and social management with economic governance and competitiveness on one hand and on the other hand, seeks to integrate environmental and social information with information about economic performance. Control of the corporate performance towards sustainable development is closely linked to the Sustainable Reporting. Companies will adopt the concept of sustainable development in case it will contribute to economic prosperity during perception of the interrelationship of environmental, economic and social performance (Schaltegger, Wagner 2006; Hyršlová 2009; Kocmanová, Dočekalová 2011).

If we take a closer look at the current outstanding results of a particular business, we will find out that they are the result of a correct decision by the management in the past (Bartes 2011).

The individual companies can be assessed in two ways (Jílek 2005). These are the following assessments: assessment by a set of indicators containing the so-called „key indicators“-these mainly concern three areas - economic, social and environmental or assessment by a single indicator (composite indicator).

Economic and financial results of company are usually measured using a set of defined financial indicators.

But how can a company obtain a complex assessment of its performance?

Non-financial key performance indicators (KPI) enable to companies to measure results toward sustainability. By incorporating the key performance indicators into their processes, the companies may get a comprehensive understanding of how well are planned their corporate sustainability goals. It is known that assessment and concentration of companies only on the financial and economic performance does not lead to long-term business success and sustainability. The investors are willing to invest smaller amounts of money in the companies that do not consider environmental and social performance, because they considere them more risky (Kruse, Lundgergh 2010). The company's performance should be considered comprehensively (Kocmanová *et al.* 2011).

Sustainability Key Performance Indicators measure progress towards sustainability and tell us about their environmental, social and economic impacts.

KPI provides quantitative or qualitative forms of feedback, which will be reflected in the results of their business strategy. The approach is no different when managing environmental, social and corporate governance issues. Use of key performance indicators in a particular company can be challenging. Before a company decides to establish key performance indicators, it is necessary to understand how they can best be used and integrated into internal management and how they can help and support Sustainable reporting. Identification and selection of key performance indicators depends on the context within the company and its industry.

One of the milestones of research in 2011 of this project was evaluation of sources for selection and use of performance measures and key performance indicators, concerning the economic, environmental, social and corporate governance aspects of business performance.

Following institutions are engaged in systematic creation of indicators with relation to environmental, social and economic performance.

- Organisation Global Reporting Initiative (GRI) created a reporting framework and set of indicators for the economic, environmental and social fields. The third version of Sustainability Reporting Guidelines (G3) was released in 2006. In March 2011, GRI launched the G3.1 Guidelines, an update and completion of the Guidelines' most recent generation.
- United Nations Conference on Trade and Development (UNCTAD) has also issued Guidelines for corporate responsibility indicators that can be included in the annual reports (Guidance on Corporate Responsibility Indicators in Annual Reports). They include review of measurement methodology for selected indicators. UNCTAD is the host of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR).
- CFA Institute – The Institute has created a manual for investors, proposing indicators of environmental, social and governance which should be considered by investors investing in companies (CFA Institute 2008)
- The European Federation of Financial Analysts Societies (EFFAS) – is a company associating financial analysts. Theirs latest task,

entrusted them by European Commission, is integration of ESG factors into investment decision-making.

- International Federation of Accountants (IFAC) prepared an overview of performance features and key performance indicators within each of the three pillars of sustainable development.

The inspiration for the creation of other indicators of corporate performance is also the work of international organizations which creates macro indicators for environmental, social and economic indicators. That concerns for example the UN, OECD, European Environment Agency, EUROSTAT etc.

3. Environmental, social and corporate governance indikátors performance

At present, the world's current term ESG characterizes the environmental, social and corporate governance performance, which investors consider in connection with corporate behaviour.

Integration of ESG includes analysis of environmental, social and corporate governance performance, as well as business risks and opportunities. It is therefore necessary to focus on the transfer of information to investors, shareholders, etc., even though most ESG indicators are voluntary. The ESG-factors so can enter directly into the setting of legislation, government's interventions, social aspects, creation of values.

ESG factors are becoming important performance indicators for investors in the European Union, but also in other global regions. Investigating ESG is becoming interesting for both the researchers, investors, analysts, but also for business managers.

FEE Sustainability Group has closely monitored the trends in ESG disclosure among EU Member States and the application of KPIs in annual accounts and management commentary looking at the implementation of the EU Modernisation Directive 2003/51/CE1. FEE considers that the disclosure of environmental and social issues and management (ESG) is important.

Accounting for Sustainability (A4S). A4S believes that organisations have to communicate clearly their impacts and response to the imperative of sustainability to investors and other stakeholders and that this is most effectively achieved through the integration of environmental and social factors into mainstream reporting (FEE 2011).

Deutsche Vereinigung für Finanzanalyse und Asset Management (DVFA) is part of an international network of industry associations and is member of the European Federation of Financial Analysts Societies (EFFAS). KPIs for ESG reflect requirements of economic stakeholders in general and investment professionals in particular. The reporting principles and specific KPIs are designed as a recommendation for profit-oriented entities (particularly stock listed companies and issuers of bonds), although it is also considered suitable for other entities regardless of size, scope and legal form. It includes general guidelines for the preparation and presentation of ESG reports and minimum requirements in respect of topics and information to be disclosed. DVFA suggests that companies formally orient ESG reporting towards the requirements of the International Financial Reporting Standards (IFRS) prepared by the International Accounting Standards Board (IASB) or other applicable GAAPs. The methodology by which the ESG KPIs were developed by the DVFA emanated from the very same ESG-related problems detailed previously (DVFA 2008).

"As more investors incorporate ESG-factors into their decision-making, the inadequacy and inconsistency of much current reporting on the issues becomes ever clearer" by Greenwald, 2009. There were conducted many studies dealing with the relationship between environmental, social and economic performance (Horváthová 2010; López-Gamero *et. al.* 2009; Barnett, Salomon 2006) and the conclusion is not unambiguous. However, companies should focus on the management of ESG-factors of the corporate performance. The positive effects arising from the management of all components of corporate performance are described for example in (Kocmanová, Dočekalová 2011).

3.1. Integration of environmental, social and corporate governance in the company performance

Creating a reliable method of measuring the performance of ESG, where the effect of more complex factors can be considered a prerequisite for success not only in decisions, but also with regard to corporate management, possibility for comparison, competitiveness of companies, etc. One possible approach is to address economic, environmental and social problems and corporate governance in relation to the measurement of business performance, as well as its continued success (sustainability success). For ESG performance data it is necessary to determine KPI. Let us consider that KPIs are organized to the four pillars (Economics, Environmental, Social and Corporate Governance) and fifth pillar Sustainability of Success (long term viability) (Kocmanova, Němeček 2009; Kocmanova, Dočekalova, Němeček, Šimberova 2011; Chvatalova, Kocmanova *et al.* 2010).

For the integration of all performance components and their modelling are suitable the qualitative methods based on fuzzy logic and mathematical-statistical methods. Appropriate statistical methods for analysis and modelling of the ESG are Person's correlations matrix, Multivariant modelling and Discrimination analysis. An example for modelling the ESG can be e.g. macroeconomic model integrating three components of sustainable development Socio-Economic Ecosystem Optimal Sustainable Growth Model (Islam 2005).

4. Methodology and empirical research on environmental, social and corporate governance performance indicators in SMEs

The empirical research was focused on environmental, social, corporate governance performance indicators in SMEs, depending on the selected CZ-NACE manufacturing industry, construction, information technology and wholesale and retail.

For empirical research were asked in total a 200 small and medium-sized business in the Czech Republic. Completed questionnaire sent back 70 companies. Criteria for the distribution of business companies according to their business field have been chosen on the basis of classification of economic activities CZ-NACE. In the investigated sample of companies was most often represented the activity in the manufacturing industry with 64.3 %, wholesale and retail trade with 18.6 % , construction with 11.4 % and information and communication technology with 5.7 %.

According to the criteria, valid in the EU, was the size structure of respondents by number of employees as follows: 21.4 % of companies with less than 10 employees, 35.7 % less than 50 employees and 42.9 % less than 250 employees.

4.1. Empirical research of environmental performance

In the Czech Republic, the environment-oriented management system is based on the ČSN EN ISO 14 000 standard represented mainly by the ČSN EN ISO 14001 standard. Setting of environmental indicators is discussed in previous research by the authors Hřebiček, Soukopová, Kutova (2010) according to the G3.0 Guideline and EMAS indicators III. The proposed KPIs shall apply to all organizations in all economic activity sectors. We will not further discuss above integrated environmental performance indicators because they were introduced and discussed in (Hřebiček, Soukopova, Štencl, Trenz 2011). Attention should mainly be paid to environmental operations that contribute to the steady growth of values for the owners; therefore, it is necessary to concentrate on the performance and long-term effects supporting sustainable development of the enterprise

The empirical analysis (Fig. 1) of voluntary environmental instruments shows that in the manufacturing industry 35.7% companies has implemented ISO 9000, 25.7% ISO 14000 and 8.6% of companies consider implementing EMAS in the future. In construction, 8.6% of companies has implemented ISO 9000, 10.0% of companies have ISO 14000, EMAS has one company. In wholesale and retail sector, 7.1% of companies have ISO 9000, 2.9% ISO 14000. In the sector of information and communication technologies has 2.9% introduced ISO 9000, EMAS is not implemented and does not even in the future.

From the empirical research results (Table 1), important environmental indicators that have an impact on corporate performance can be derived, see Table 1.

For the measurement of environmental performance, following indicators are considered as important.

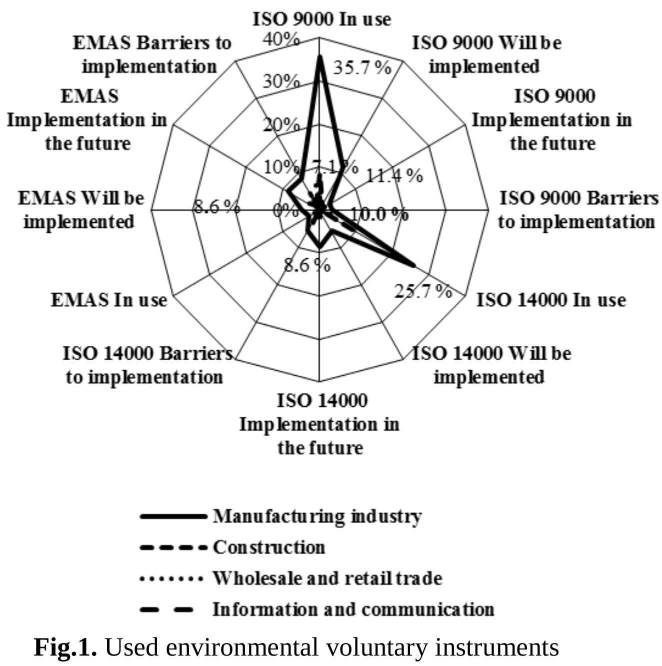

Fig.1. Used environmental voluntary instruments

Table 1. The significant environmental aspect

	CZ-NACE			
	Manufacturing industry	Construction	Wholesale and retail trade	Information and communication
Emissions to air	17.1 %	1.4 %	4.3 %	-
Emissions to water	15.7 %	2.9 %	1.4 %	-
Waste	38.6 %	10.0 %	8.6 %	-
Hazardous waste	20.0 %	4.3 %	7.1 %	-
Odour, noise, radiation, vibration	21.4 %	5.7 %	2.9 %	-
Soil	7.1 %	5.7 %	1. 4 %	-
Effect on landscape	11.4 %	5.7 %	2.9 %	-
Accident	14.5 %	2.9 %	1.4 %	-
Consumption of power and heat	42.9 %	4.3 %	10.0 %	4.3 %
Water consumption	31.4 %	1.4 %	4.3 %	2.9 %
Consumption of materials and raw materials	37.1 %	7.1 %	2.9 %	2.9 %

In manufacturing industry, it is waste 38.6 %, odour, noise, radiation, vibration 21.4%, hazardous waste 20.0 %, emissions to air 17.1 %, accidents 14.5 %, consumption of power and heat 42.9%, consumption of materials and raw materials 37.1 % and water consumption 31.4 %. In constructions, important indicators are: waste 10.0% and impact on soil and effect on landscape 5.6 %. For wholesale and retail trade. Important indicators are: consumption of power and heat 10.0% and waste 8.6 %. In information and communication technologies, an indicator of consumption of power and heat is important.

4.2. Empirical research of social performance

Currently, the best known international standards for activities and dealing with social indicators are: OECD Guidelines for Multinational Enterprises; Dow Jones Sustainability Indexes (DJSI); Corporate Social Responsibility (CSR); Socially Responsible Investment (SRI); Social Accountability 8000 (SA8000); ISO 26000-Social responsibility.

The trend, which emphasizes the social aspects of sustainable development, is the concept of CSR (Corporate Social Responsibility). The areas where corporate social responsibility (Trnková 2004) may play a role are many and they differ according to the field of the company's operation, both geographically and culturally. Social Accountability 8000 (SA8000) is aimed at improving working conditions. The standard is introduced by those companies that want to declare that not only give due attention to control quality, but also to health and safety of workers and appropriate conditions for their further development in working and personal life. ISO 26000-Social responsibility serves as a guide for social responsibility.

An important social element is the Occupational Safety and Health (OSH). In the Czech conditions deserves the attention the OHSAS 18001 Occupational Safety and Health.

The empirical analysis shows (Fig. 2), that in manufacturing industry prevails occupational safety and health protection and fire protection 63.5 %, CSR use 12.9 % companies, Safe company 14.3 %. In construction, wholesale and retail trade and information and communication technologies, companies do not consider these instruments important and do not plan to implement them in the future.

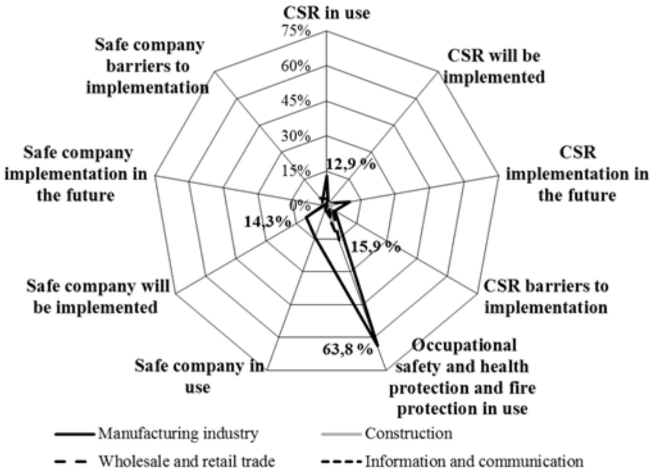

Fig.2. Used social voluntary instruments

From the empirical research results (Fig. 3), important social indicators that have an impact on corporate performance can be derived.

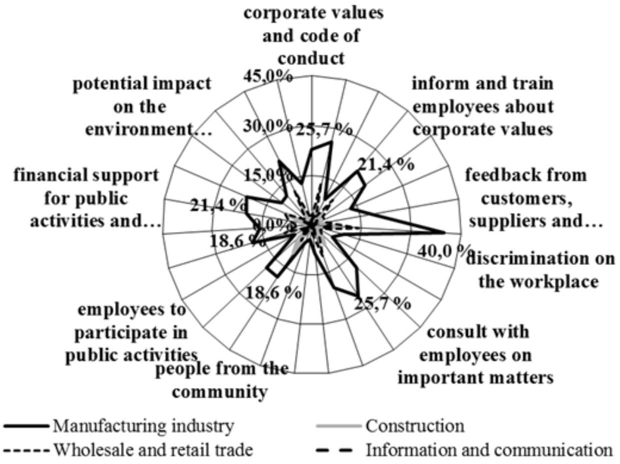

Fig.3. The responsible behavior in the company

To measure the social performance following indicators are important. In manufacturing industry, important indicators are: feedback from customers and suppliers 40.0%, defined values and rules 25.7%, relations with employees 20.0%, financial support to public activities and impact of a product on the environment 20.0%. In construction, there are important relationships with customers and suppliers 8.6%, public financial support 8.6%, impact of products on the environment 7.2% and dialogue with communities and employees 7.1%. In wholesale and retail trade, important indicators are: feedback from customers and suppliers 14.3%, corporate values 12.9%, and relations with employees. For IT companies are indicators in the same order as in the manufacturing sector.

4.3. Empirical research of corporate governance

As historically crucial for the development of codes of corporate governance is now considered primarily British code from the (Cadbury commission 1992) and the following Unified code of the London Stock Exchange (The Combined Code 1998). In connection with Corporate Governance in relation to the OECD Principles from 2004, drew also from the recommendations of the European commission[1]. Czech companies are now governed by the Code of Corporate Governance, based on OECD Principles 2004 (Ježek 2006).

OECD Principles are the results of effort for an internationally acclaimed document, without a clearly defined scope which can individual countries apply voluntarily (OECD 2004).

[1] These recommendations are included in the document „*Modernizing Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward*“

Measuring of administration and management levels of a concrete company is relatively difficult, since in the evaluation enters a large part of subjective assessment. However, there are some methods for measuring the level of individual companies, sectors or countries (Cadbury 1992).

Qualitative approaches use evaluation and analysis comparing the extent to which the above mentioned codes of good practice are observed. Companies are ranked according to how strictly they comply with the various principles and recommendations in the Codes, by identifying the Corporate Governance Index. Empirical studies have shown correlation between the level of management and administration and the business success in meeting its objectives, especially the rise of shareholder's value. It was confirmed that the companies that have subscribed to one of the Codes of good practice and comply with the declared procedures are more attractive for shareholders and investors.

Corporate governance performance is the question of risk, specifically leadership risk. We consider in company: *governance processes and structure; profiles and competencies; culture, behaviour and team dynamics.* (Hřebiček, Štencl, Trenz, Soukopova 2011)

Corporate Governance by authors (Baker, Anderson, 2010) examines the ways in which corporations are led, administered and controlled.

The empirical analysis (Table 2) shows that there is no relation between corporate governance and voluntary reporting. Voluntary information are mostly published in a cumulative report.

Very surprising results from empirical analysis relate to CG and its interest in stakeholders. In the manufacturing industry, there is interest of stakeholders in following order: customers, investors, employees and contractors. In construction: public, customers, government, and at the same level as employees, investors and suppliers. In wholesale and retail trade: investors and customers. In information and communication technologies: employees and at the same level as customers, competitors and suppliers. The greatest emphasis is placed on making the relationship between the business owners and the shareholders more efficient, in the broader sense also the relations with the other interest groups (Keasey *et al.* 1999).

From the empirical research results, an important CG indicator can be derived and they should be integrated with the Code of Corporate Governance.

Table 2. Publishing voluntary reporting companies

		CZ-NACE			
		Manufacturing industry	Construction	Wholesale and retail trade	Information and communication
Report on environmental protection	Rather Yes	4.3 %	2.9 %	1.4 %	1.4 %
	Definitely Yes	10.0 %	-	1.4 %	1.4 %
	Rather Not	12.9 %	-	5.7 %	1.4 %
	Definitely Not	28.6 %	8.6 %	7.1 %	1.4 %
Report on responsible business	Rather Yes	-	-	1.4 %	-
	Definitely Yes	5.7 %	-	-	2.9 %
	Rather Not	17.1 %	-	4.3 %	-
	Definitely Not	24.3 %	8.6 %	8.6 %	1.4 %
Report on sustainable development	Rather Yes	7.1 %	-	1.4 %	-
	Definitely Yes	1.4 %	-	-	1.4 %
	Rather Not	12.9 %	-	4.3 %	1.4 %
	Definitely Not	27.1 %	10.0 %	10.0 %	2.9 %
Otherwise cumulative report	Rather Yes	21.4 %	1.4 %	5.7 %	-
	Definitely Yes	24.3 %	2.9 %	2.9 %	4.3 %
	Rather Not	2.9 %	-	2.9 %	-
	Definitely Not	7.1 %	5.7 %	5.7 %	-

5. Conclusions

The environmental, social and Corporate Governance create the core of the company and commercial strategy, they could be included in the everyday operations, challenge for success, indicator of danger and risks and incentive for a chance. And they should of course become part of the voluntary company reports about evaluation of the relations among the environmental and economical assessment of the performance, social evaluation of the performance and relation to the corporate governance. Although the environmental performance and corporate governance performance have no direct relationship (Salo 2008), we can say that the environmental performance and corporate governance individually contribute to overall performance.

It is important to create measurable and relevant objectives for sustainability and appropriate metrics. Companies that provide insufficient and incomplete information, inadequate also from the time point of view, are considered by investors as riskier and therefore the investors are less willing to invest in these enterprises. Hence, the solution is offered by reporting integrated financial and non-financial indicators. The same principles should be applied to both financial and non-financial indicators as well. In both cases they should be relevant, measurable, comparable, motivating and easily detectable. As more investors incorporate ESG factors into their decision-making, the inadequacy and inconsistency of much current reporting on the issues becomes ever clearer (Greenwald, 2009).

The results of the empirical research in small and medium-sized enterprises shows conclusions for the next research, in particular a determination of ESG performance indicators. These performance indicators should be included in corporate sustainability reporting. Based on the empirical research, the focus of the next research is to determine the ESG performance indicators in manufacturing industry and construction for large companies (over 250 employees) with implemented ISO 14 000 or EMAS.

Acknowledgements

“This paper is supported by The Czech Science Foundation. Name of the Project: Construction of Methods for Multifactor Assessment of Company complex Performance in Selected Sectors. Reg. Nr. P403/11/2085 “

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