

ESG and Corporate Performance: A Review

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Abstract: ESG is becoming increasingly important topic in corporate finance literature. In addition to developed countries, emerging market economies have also increased their attention on ESG in recent years. The number of papers on ESG published by finance and accounting journals skyrocketed. The effect of ESG on corporate performance is uncertain. This paper provides implications for investors, ESG can build up reputation, transmit positive signals, and investors react positively to socially responsible firms, increasing corporate performance. On the other hand, according to the agency theory, more ESG involvements may reflect managerial opportunism, which negatively affects corporate innovation. This paper aims to provide a synthetic and evaluation monograph of literature that examines the relationship between ESG and corporate performance.

Keywords: ESG; Corporate Performance; Stakeholder Theory

1. Introduction

The past decade has seen the world was experiencing an increment in the number of investors taking environmental (i.e., greenhouse gases emission, water contamination, natural resources allocation, etc.), social (i.e., labor standard, working conditions, Community participation, etc.), and governance (i.e., corporate governance, Managerial Decision, etc.), collectively ESG data as an important factor in investment. As ESG investment is an effective risk management, because companies with high ESG ratings have a stronger sense of ethics and are less likely to commit financial fraud. For firms, the disclosure of ESG data helps enterprises to enhance its brand image, which attract financing, in order to reduce financing costs and improve valuation. Originally proposed by the United Nations Global Compact in 2004, ESG include three dimensions: environment (E), society (S) and corporate governance (G).

In this study, I summarize the literature on the relationship between ESG and corporate performance. In general, this paper documents a positively association between ESG and corporate performance. On the one hand, one of the key elements that gives businesses a distinct competitive advantage is innovation (Calantone et al. 2002; Knight and Cavusgil 2004; Xie et al. 2018). ESG can boost corporate performance and competitive edge by increasing green innovation. Through green innovation, ESG companies may enhance attractiveness of products and services and cut production costs, which increases operation efficiency. On the other hand, ESG fulfillments build up reputation and firms with better ESG

performance gain positive feedbacks from various stakeholders, including suppliers, customers, and debtholders. The paper is organized as follows. Section 2 presents the beneficial effects of ESG and section 3 offers the relationship between ESG performance, investor confidence and listed company performance

2. The positive influence of ESG

There has been heated discussion surrounding the issue of how ESG considerations impact a company's financial performance and, ultimately, its value. According to El Ghouli and Karoui's (2020) analysis of 53 countries' ESG performance and company value, ESG performance is positively correlated with firm value, particularly in nations with weaker market-supporting institutions. According to Fatemi et al. (2018), in terms of financial performance, strategic asset allocation strategies take ESG objectives and analysis into account in order to gradually reduce ESG risks and improve financial performance. Given that ESG elements often have a low frequency but large influence on long-term performance, practitioners who are long-term investors are likely to include ESG factors more frequently than short-term investors. As a result, a company that has achieved good ESG performance may choose to voluntarily disclose more information about its ESG activities, which increases its firm value (Battisti et al., 2019; Wong et al., 2020; Murashima, 2020). In conclusion, Environmental, Social, Governance practice and financial performance are favorably correlated

Secondly, more businesses who want to get a competitive edge and high market rates are becoming interested in

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green innovation in today's competitive environment. These inventions often strive to recycle, replace scarce resources with sustainable ones, decrease waste, boost energy production, and minimize pollution (Harel et al., 2020). Green innovation is being emphasized more and more by academics and policymakers as a means of solving environmental problems (Kiviima, 2008) and enhancing business sustainability. (Kallio and Nordberg, 2006). According to existing literature, eco-friendly innovation incorporates ecological principles into the creation process to prevent or minimize environmental impact (Gunasekaran and Spalanzani, 2012). As a result, there is a successful synergy between the firm's and the environment's objectives. From a variety of angles, green innovation not only improves a company's environmental performance but also gives it a competitive edge.

In their 2013 study, Aguilera-Caracuel and Ortiz-de-Mandojana sought to ascertain the effect of green innovation on the performance of environmental enterprises, including both the company's competitive advantage and environmental performance. The findings of this study demonstrate how environmental practices prohibit companies that engage in green innovation from benefiting financially from its advantages. The goal of raising knowledge of green innovation is to improve environmental performance, but it also affects financial performance and competitive advantage (Chiou et al., 2011). Green innovation therefore enhances the performance of environmentally conscious businesses (Lin et al., 2013). When concentrating on green innovation companies, we observe that the level of green innovation is positively correlated with the firm's profitability. Therefore, the improvement of environmental quality or the best use of natural resources are classified as green innovation facilities (Rave et al., 2011). These outputs might be financial results like more profitability, more income, or new investments.

One of the key elements that gives businesses a distinct competitive advantage is innovation (Calantone et al. 2002; Knight and Cavusgil 2004; Xie et al. 2018). Through green innovation, ESG companies may enhance internal operation efficiency while cutting costs. Thus, one of the best methods to reap the rewards of environmental growth is through green innovation. Gueguen and Isckia (2011) contend that an organization's capacity for innovation can provide them a competitive edge. Therefore, we suggest that the beneficial influence on an ESG firm's corporate financial performance will be stronger the higher the level of green innovation intensity. Improved financial success at the business level is positively correlated with high levels of green innovation intensity. If ESG practices can change how businesses innovate in the green space, then green innovation will have a beneficial impact on financial performance (Liu et al., 2017; El-Kassar and Singh, 2019).

Third, the beneficial association between ESG practices and financial success is supported by several research (Ioannou et al. 2016; Fatemi et al. 2018; Khan, 2019). According to the reputation theory, better ESG fulfillments can help listed firms build up reputation, which is an important intangible asset for firms. Businesses with better ESG performance recognize and

evaluate the needs of many stakeholders. And stakeholders will give positive feedbacks to these firms. For instance, customers are willing to purchase products and services of socially responsible firms, which increase product market performance. As for suppliers, they are willing to provide more trade credit capital to these firms. For debtholders, they may decrease the cost of debt capital to firms with better ESG fulfillments. In addition, in order to gain a higher ESG rating, listed firms have incentives to improve corporate governance and increase information transparency, which in turn improves corporate performance.

3. The relationship between ESG performance, investor confidence and listed company performance

Many listed firms now participate in ESG practices not just as a result of external pressure or the management's own self-interest, but also as an unplanned action with the intention of adding value as society awareness and the ESG system continue to advance. The ESG value-added theory, which contends that ESG performance has a favorable influence on corporate value, is supported by most study findings. Companies with great ESG performance typically also have strong risk management, outstanding credit quality, and high levels of financial success. Companies that improve their ESG management can not only lower their financing costs, but also boost their market value. Additionally, the market value will rise (Fatemi et al., 2017; Qiu M and Yin, 2019).

Strong ESG performance helps listed firms acquire the respect of key stakeholders. First, it is easier for listed companies to forge positive relationships with the government when they perform well in ESG and achieve a relaxed environment for their own development. For the government, listed companies with stronger economic strength and greater social influence are the "key minority" to be grasped in order to promote ESG development (Liu, 2016). Leading listed firms have greater opportunity to gain financial support and preferred policy treatment since the government plays a significant role in resource allocation, which improves financial performance.

Second, for consumers, listed companies with good ESG performance have a superior level of governance and tend to have better quality products, which helps to enhance consumers' trust, recognition and satisfaction, and increase their willingness to purchase (Hu et al., 2016); at the same time, listed companies with good ESG performance have made achievements in environmental and social issues, which can attract some environmentalist consumers. Therefore, improvement in ESG performance can lead to an increase in market share or operating income, which can have a positive impact on financial performance.

Third, for internal employees, the excellent ESG performance of listed companies indicates that the companies have a good corporate culture, which can create a good working atmosphere for internal employees, increase their sense of identity and belonging, reduce staff

turnover, and help maintain the stability of the company's daily operation (Bridges & Harrison, 2003). In addition, listed companies with good ESG performance generally have high governance capabilities and can motivate employees to work through relatively reasonable performance evaluation criteria and promotion mechanisms, thus improving work efficiency and promoting the improvement of the listed company's financial performance.

Fourth, for investors, their basic interests are to preserve and increase the value of their invested capital and to receive dividend returns. Listed companies with good ESG performance have high governance efficiency and less risk of violation of environmental and social events, which can reduce the possibility of investors' investment loss and bring stable returns to investors. Listed companies that actively undertake ESG responsibilities can enhance investors' confidence and drive up stock prices (Lei et al., 2012), which in turn leads to better market performance.

Fifth, for creditors, because financial institutions are the primary creditors of companies and are influenced by the green finance reform, they are more willing to offer preferential lending services to support economic activities like environmental improvement, combating climate change, and resource conservation and efficient use. As a result, listed companies with strong ESG performance can lower the cost of debt capital and improve their market performance through the leverage effect. To sum up, the ESG performance has a significant positive impact on the market performance and financial performance of listed companies. In addition, Good ESG performance of a listed company can boost its investor confidence.

(1) Good ESG performance can send favorable signals to investors. While practicing ESG concepts, listed companies will convey their good values to the outside world, making investors aware that the company is consciously taking social and environmental responsibilities and striving to improve its governance, as well as indirectly signaling to investors that the company's earnings are stable, which is conducive to attracting investors' attention and investment. (2) Good ESG performance can reduce the risk faced by investors. ESG performance of listed companies conveys non-financial information to investors, which provides an information basis for objectively evaluating company value and reducing investment risks. In general, companies with good ESG performance not only actively implement the concept of green development and assume social responsibility, but also have a scientific and reasonable internal governance and supervision system that can effectively manage risk (Sassen et al., 2016), improve the science and effectiveness of business decisions, ensure that the company's operations are in line with the correct strategic goals and development direction, and reduce losses to investors due to ignoring or underestimating non-financial risks. financial risks to investors, etc., thus improving investor confidence. (3) Investors can more easily determine the caliber of investment targets by using good ESG performance as a major indicator of a company's sustainability. Typically, publicly traded

companies with strong ESG performance benefit more from resource efficiency, social responsibility, and corporate governance, and they are better able to maintain stability and profitability through volatile market conditions (Ge et al., 2013).

4. Conclusions

Since 1992, the United Nations Environmental Programme Financial Initiative (UNEP FI) has advocated for financial institutions to incorporate environmental, social, and governance (ESG) considerations into their decision-making processes. Academic researchers in financial economics have paid a lot of attention to the topic of finance and ESG as it has grown in importance. The number of papers published in finance and accounting journals and accepted for presentation has experienced a tremendous growth in the past few decades. The relationship between ESG and corporate value has two distinctive views, one promotes and the other inhibits. This paper provides a synthetic and evaluative monography of academic papers that examine the relationship between the ESG and firm performance, also provides the insights and opinions on prospective research topics in finance and ESG. The limitation of this paper is that this study didn't mentioned the negative influence of ESG, so the future direction of ESG and corporate performance will be focus on the negative and insignificant influence of ESG on corporate performance.

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