Assessing the Impact of Environmental, Social, and Governance (ESG) Factors on Corporate Performance: A Literature Review

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ABSTRACT

In recent years, Environmental, Social, and Governance (ESG) principles have gained significant attention among the industry players as well as academia. It is a framework for evaluating the sustainability and ethical practices of corporations in generating profit. ESG is environmental, social, and governance practices that impacted the long-term value of a business. This conceptual research aims to provide an overview of ESG, its underlying principles, and the importance of adopting an integrated approach to ESG in corporate business planning. In current environment, ESG has become one of the criteria for investor evaluating stocks and for firms it is one of their portfolios to become as socially responsible as possible. Therefore, firms are taking action to report their performance on these risks broadly through three categories namely Environment, Social and Governance (ESG) to attract investors. Nonetheless, it is a dilemma to the firms as this reporting is an investment that demand financial sense to the operation of the firms. Therefore, adopting an integrated approach to ESG is crucial for corporations to navigate the challenges and opportunities of a rapidly changing business landscape. By embracing sustainability, ethical practices, and strong governance, companies can not only mitigate risks but also unlock new avenues for growth, enhance brand reputation, and contribute positively to the broader society and environment. ESG integration represents a transformative paradigm that can shape the future of corporate sustainability and responsible business conduct.

Keywords: Environment, Social, Governance, Reporting, Profitability

1. INTRODUCTION

ESG considerations have gained significant attention in recent years, with investors and stakeholders recognizing their potential influence on financial outcomes. This paper examines various studies and frameworks that explore the relationship between ESG factors and corporate performance, highlighting both positive and negative impacts. By synthesizing the existing research, this article aims to contribute to the understanding of ESG's role in shaping corporate strategies and outcomes. Thus, companies are put under pressure to increase their efforts and keep an eye on non-financial aspects of their work due to the growing interest of investors and a surge in global awareness of risks associated with non-financial factors, particularly the environment like social responsibility and proper governance to show performance. These three factors have emerged as key determinants of corporate performance in the modern business landscape. For those reasons, companies are facing increasing pressure from investors, regulators, customers, suppliers, and society to incorporate sustainability and social responsibility into their operations, thus, making understanding the link between ESG factors and financial outcomes becomes crucial. Added by Christensen, Hail & Leuz (2021) in a Business Roundtable Statement in 2019 mention that the executives attended the discussion were responding to a strong pressure that a company needs to do “good” while doing business, be it keeping carbon emissions low, waterways clear, or workers healthy are a good sign of companies investing on sustainability.

Thus, the government has strategies efforts and initiatives in promoting the reporting by requirement from Securities Commission Malaysia (SC) towards listed companies by issued the Malaysian Code on Corporate Governance (MCCG), which emphasizes the importance of sustainability reporting and encourages voluntary disclosures on ESG matters. As for Bursa Malaysia the Malaysian stock exchange introduced the "Sustainability Reporting Guide" in 2015. This guide provides voluntary reporting recommendations for listed companies on sustainability-related matters, including ESG factors and as part of corporate governance practices. Other than that, a Sustainability Reporting Frameworks named as Global Reporting Initiatives (GRI) to structure their sustainability reporting. A part from the government role play, the industry, associations, and networks from various industry support and promote sustainable business practices and ESG reporting. These industries players provide guidance, training, and resources to companies, including SMEs, to help them understand and adopt sustainable practices. Financial Institutions as well are increasingly integrating ESG factors into their lending and investment practices by requiring companies to provide ESG information and reports as part of their due diligence process. These strategies and initiatives come from the support of the government including financing schemes, capacity-building programs, and incentives for companies to adopt sustainable practices, including ESG reporting. These efforts collectively aim to raise awareness, provide guidance, and create an enabling environment for companies in Malaysia to embrace ESG reporting and sustainable practices.

2. ESG FACTORS AND CORPORATE PERFORMANCE:

Environmental Factors

Numerous studies have investigated the relationship between environmental factors and corporate performance. For example, research by Jones et al. (2016) demonstrates a positive correlation between environmental sustainability practices and long-term financial performance. Similarly, Schaltegger and Wagner (2020) highlight the potential cost savings and competitive advantages associated with proactive environmental management. A more recent studies on ESG impact to the environment by Aydogmus, Gulay and Ergun (2022) found no relationship between environment to firm value and profitability as the study argued that environment is related with actions which may take longer time to produce outcome for firms as to be compared to social or governance related actions. Another point is high investment costs associated with environment project. However, in a combined score between environment, social and governance show a different side of the coin as it resulted to positive and significant relationship with firm profitability. In 2021, research by Ika et.al found larger companies and companies owned by an institution in Indonesia have a higher tendency to report carbon emissions which relate to environment either in the firm's annual report or in the sustainability reporting. This shows that a strong governance could also contribute to the protection and retention of the environment. Since 2007, Campbell did mention that companies are likely to improve their social and environmental performance to acquire trust, legitimacy and respond to institutional pressures (Campbell, 2007).

In addition, ESG disclosures also becomes popular among the public listed companies as it shows inclusion of stakeholders, responding to investor demand, establishing credibility, and reacting to crises and competition (Olsen et al., 2021). Aa noted by Friede et al. (2015), more researches are trying to prove the link between ESG and corporate financial success since 1970s but with a different term other than the ESG. After reviewing 2200 papers, the study conclude that the research validates the rationale for investing in ESG and that about 90% of

the studies indicated a favourable relationship between ESG and firm financial performance. Another meta-analysis in 2018 by Alshehhi et al., of 132 published reputable and credible studies reveals that 78% revealed a positive relationship between sustainability and financial performance of the firm. Same findings from the study by Bhaskaran et al. (2020) which review the impact of ESG on financial performance of 4,887 firms from 2014 to 2018 using firm value (Tobin's Q) and operational performance (ROE and ROA) as dependent variables. They indicate that firms with high performance on environment, governance, and social pillars tend to create more value in the market. The study had identified firms with ESG activities on welfare activities for internal stakeholders and good corporate governance practices are valuable for firm performance and the antitakeover mechanisms (pollution control) adopted by firms are also positively valued by the market players.

Social Factors

On the social perspective dimension of ESG encompasses issues related to human capital, employee welfare, and community engagement. Research by Edmans (2018) indicates that companies with high employee satisfaction levels tend to outperform their peers. Moreover, studies by Margolis et al. (2007) emphasize the positive impact of corporate social responsibility initiatives on brand reputation and consumer loyalty. Along with the growing interest in sustainable investments, the demand for information about corporate social responsibility (CSR) as well as firms' environmental, social, and governance (ESG) activities and policies has steadily risen. It is commonly to associate CSR to sustainability, though it is in common but it is not the same. CSR is most commonly implying to a broader objective which relates to corporate contribution to the public and environment. While, sustainability is more than maximizing its market value by trying to meet the needs and expectations of a wider set of stakeholders or society. Therefore, in performing sustainability, firms may sacrifice profits to gain the non-financial value from the stakeholder and the shareholder. However, corporate may consider investing in ESG value creation as it is the time where value creation depended on sound investment of digital transformation, leveraging on employees' expertise, client base, patents, and R&D. Businesses may be encouraged to adopt sustainable practices by external pressure from stakeholders, although managers' short-term profit orientation is frequently compromised by these objectives (Kamaludin et al., 2022). Promoting ESG activities offers benefit for firms rather than conflicting with shareholders' desire to maximize profits (Eccles & Klimenko, 2019). Advancement of ESG activities really adds value for businesses rather than conflicting with shareholders' desire to maximize profits (Eccles & Klimenko, 2019; Hampton, 2012; Watson, 2011). The significance of investing in a company's intangible and soft assets is emphasized by ESG reporting. Therefore, investors have increasingly considered ESG factors in their investment decision-making processes. Studies by Kotsantonis et al. (2019) demonstrate a positive relationship between ESG performance and credit risk, highlighting the relevance of ESG considerations for bondholders. Moreover, Flammer (2021) explores the impact of ESG investing on stock returns, indicating a positive relationship between ESG scores and financial performance.

Governance Factors

Effective corporate governance is crucial for mitigating risks, ensuring transparency, and safeguarding shareholder interests. Research by Bebchuk et al. (2022) reveals a positive correlation between strong governance practices and firm value. Additionally, Gompers et al. (2020) find that companies with diverse boards exhibit superior financial performance and innovation. It is common that institutional investors seek sustainable investments delivered through strong ESG commitments (Eccles & Klimenko, 2019). Such inconsistency in incentives creates agency conflicts can be mitigated through effective corporate governance,

particularly an effective board. An effective board provides monitoring, oversight, advice, and counsel that aligns managerial and shareholders' interests (Kamaludin et al, 2022), thus board characteristics influence ESG initiatives and reporting. KPMG stated that sustainability reporting may fulfil the regulatory requirements, but still appears to lack meaning, context, and influence. Studies on ESG disclosure and reporting in the Malaysian context are still relatively limited and have shown mixed findings. Several leading studies have suggested that independent boards contribute negatively to ESG disclosure (Hanifa & Cooke, 2005 and Esa & Ghazali, 2012), women on Malaysian boards do not affect sustainability practices because of their minimal representation (Alazzani et al., 2019), and the frequency of board meetings does not contribute to sustainability reporting and practices (Ahmad et.al, 2017). ESG creates long-term value for the firm, many managers are still focused on profit maximization in the short-term. Tus, we believe that effective corporate governance mechanisms, particularly an effective board, are critical to enhance ESG initiatives and disclosure. Arguably, if the company prioritises delivering ESG as part of its long-term success and future viability, an effective board would ensure that the company is set to achieve this. A recent study by Kezey et.al (2023) find that sample of 43,803 firms in 41 countries with strong voice and accountability, political stability, government effectiveness, regulatory quality, rule of law and control of corruption are more motivated for ESG engagement. Furthermore, corporate governance negatively moderates the relationship between all public governance dimensions (except political stability) and excessive ESG engagement. This implies that public governance and corporate governance are substitutes for encouraging firms to commit to ESG. Further tests reveal that whereas these results in the baseline analyses are valid for developed countries, they are not valid in emerging markets.

Integrated Reporting and Disclosure

The adoption of integrated reporting and comprehensive ESG disclosure practices enables companies to communicate their ESG strategies and performance to stakeholders effectively. Research by Ashrafi et al. (2018) suggests that integrated reporting facilitates better decision-making by investors and enhances firms' access to capital. Similarly, Bassen et al. (2021) emphasizes the importance of transparent and standardized ESG reporting frameworks. Presented by Johnathan Labrey during the AFA-MIA-CPA Australia in 2021 discussed on integrating the sustainability reporting and financial reporting as it rewarded the capital market in ways that the reporting contributed to lower cost of capital (Nanyang Business School), stock liquidity and firm value (Stanford University), higher share price performance (University of Singapore) and long-term investor (Harvard Business School). ESG disclosure is reporting of value and non-financial information that indeed gives impact to the profitability. A study by Leng, Lazar and Othman (2007), on the first-time adoption of financial reporting after the introduction of new Financial Reporting Standard (FRS) among Malaysian public listed companies found that the biggest drawback in the implementation process was the lack of briefing to financial analysts and investors on the impact of FRS on the company's financial statements. In Malaysia after the financial crisis in 2008, Maybank had embarked their first move on reporting sustainability to enhance its credibility on the sustainability issues (Tan and Hamid,2017). Another renown company in 2021 brand health survey conducted by an independent third-party market survey analyst, Digi was rated highest amongst the Malaysian telcos by Malaysians on our ESG performances. The step undertaken by Digi is in accordance to Sahar et.al (2022) pointed out that telcos are now implemented sustainability management strategies, such as being mindful of the environment given the amount of energy they use to power their base stations and network equipment; offering universal service providers at competitive prices to all customers, even it impacted financially for telcos in many ways.

3. CONCLUSION

This research article provides a review of the literature on ESG factors and their impact on corporate performance. The findings indicate that ESG considerations have the potential to influence financial outcomes positively by driving operational efficiency, enhancing reputation, and attracting sustainable investments. However, further research is needed to explore specific industry contexts and the long-term effects of ESG integration on financial performance. Public and corporate governance objectives are served by attending to stakeholders' interests. Corporate governance focuses on allocating firm resources for more ESG participation, while public governance primarily addresses the institutional and legal environment. A rise in social consciousness and ecological concerns, including climate change, along with growing stakeholder knowledge, has spurred public and corporate governance interest in ESG participation.

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