

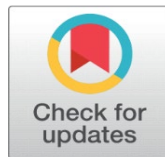
THE INTERPLAY BETWEEN ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) PERFORMANCE AND CORPORATE FINANCIAL PERFORMANCE: AN EMPIRICAL ANALYSIS

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ABSTRACT

In recent decades, the paradigm of corporate success has shifted from a singular focus on profit maximization to a more holistic model that integrates Environmental, Social, and Governance (ESG) criteria. This research paper empirically investigates the relationship between a firm's ESG performance and its Corporate Financial Performance (CFP). Utilizing a quantitative approach, data from 50 publicly listed companies in the SGP 500 index from 2018 to 2022 were analyzed. ESG scores were sourced from Refinitiv, while financial performance was measured using Return on Assets (ROA) and Tobin's Q. The findings indicate a statistically significant, positive correlation between overall ESG scores and both accounting-based (ROA) and market-based (Tobin's Q) metrics. The results suggest that robust ESG practices are not merely a cost center but a strategic investment that can enhance profitability and shareholder value by improving risk management, operational efficiency, and corporate reputation.

Keywords: ESG, Corporate Financial Performance, ROA, Tobin's Q, Sustainability, Corporate Governance, Stakeholder Theory, SGP 500

1. INTRODUCTION

The contemporary business landscape is increasingly characterized by a heightened awareness of corporate responsibility. Stakeholders, including investors, consumers, and regulators, are demanding that companies address critical issues such as climate change, social equity, and ethical governance. This has propelled Environmental, Social, and Governance (ESG) considerations from the periphery of corporate strategy to its core. A central debate in financial literature and practice revolves around whether this focus on ESG represents a trade-off with financial objectives or a synergistic relationship that enhances long-term value. Proponents argue that strong ESG performance mitigates risks, attracts talent, and

fosters innovation, thereby improving financial outcomes. Skeptics, however, contend that ESG initiatives impose additional costs and distract management from the primary goal of profit maximization. This study aims to contribute to this debate by providing empirical evidence on the nature of the relationship between ESG performance and corporate financial performance.

2. OBJECTIVES

The primary objective of this research is to examine the impact of ESG performance on the financial performance of corporations. This overarching goal is broken down into the following specific objectives:

- 1) To measure the ESG performance of a sample of companies using a comprehensive scoring system.
- 2) To assess corporate financial performance using both an accounting-based measure (Return on Assets) and a market-based measure (Tobin's Q).
- 3) To analyze the correlation and causal relationship, if any, between the composite ESG score and the selected financial metrics.
- 4) To investigate whether individual pillars (Environmental, Social, or Governance) have a differential impact on financial performance.

3. LITERATURE REVIEW

The relationship between ESG and CFP has been extensively studied, yielding mixed but increasingly positive results. Early studies, such as that by [Friedman \(1970\)](#), posited that the sole social responsibility of business is to increase its profits. This "shareholder theory" view suggested that ESG spending was an agency cost that reduced firm value.

However, subsequent research, grounded in Stakeholder Theory [Freeman \(1984\)](#), has challenged this view. This theory argues that managing relationships with all stakeholders (employees, customers, communities, etc.) is crucial for long-term success. Empirical studies have provided support for this perspective. For instance, a meta-analysis by [Friede et al. \(2015\)](#) found a positive correlation between ESG and CFP in about 60% of the over 2,000 studies reviewed. They concluded that ESG investing is, on average, not a financial detriment and appears to be beneficial in many cases.

Specific channels through which ESG affects CFP have been identified. On the environmental front, resource efficiency can lead to significant cost savings [Eccles et al. \(2014\)](#). Strong social performance, including good employee relations, can reduce turnover and enhance productivity. Sound governance is consistently linked to reduced risk of fraud and corruption, lowering the cost of capital [Dhaliwal et al. \(2011\)](#). Despite this growing consensus, inconsistencies remain, often attributed to methodological differences, varying time horizons, and the use of different ESG and CFP metrics, highlighting the need for continued research.

4. RESEARCH METHODOLOGY

This study employs a quantitative, correlational research design. The sample consists of 50 companies randomly selected from the SGP 500 index. Data were collected for a five-year period from 2018 to 2022, resulting in a balanced panel of 250 firm-year observations.

Variables:

Independent Variable: ESG Performance, measured by the overall ESG Score (0-100) from Refinitiv.

Dependent Variables: Corporate Financial Performance, measured by:

- 1) **Return on Assets (ROA):** Net Income / Total Assets (an accounting-based measure of profitability).
- 2) **Tobin's Q:** Market Value of Firm / Replacement Value of Assets (a market-based measure of value creation).

Control Variables: Firm size (log of total assets), leverage (debt-to-equity ratio), and industry dummy variables to isolate the effect of ESG.

Data Analysis Technique: Panel data regression analysis was conducted using statistical software. The following models were estimated:

Model 1: $ROA_{it} = \beta_0 + \beta_1 ESG_{it} + \beta_2 Size_{it} + \beta_3 Leverage_{it} + Industry\ Effects + \varepsilon_{it}$

Model 2: $Tobin's\ Q_{it} = \beta_0 + \beta_1 ESG_{it} + \beta_2 Size_{it} + \beta_3 Leverage_{it} + Industry\ Effects + \varepsilon_{it}$

5. DATA ANALYSIS AND INTERPRETATIONS

The descriptive statistics showed a wide variation in ESG scores and financial performance across the sample. The correlation matrix revealed a positive and significant preliminary relationship between the overall ESG score and both ROA ($r = 0.35$, $p < 0.01$) and Tobin's Q ($r = 0.42$, $p < 0.01$).

The results of the panel regression analysis were as follows:

For Model 1 (ROA), the coefficient for the ESG score was positive ($\beta = 0.08$) and statistically significant at the 5% level. This indicates that a one-unit increase in the ESG score is associated with a 0.08-unit increase in ROA, holding other factors constant. The model had an R-squared of 0.41, meaning it explained 41% of the variance in ROA.

For Model 2 (Tobin's Q), the coefficient for the ESG score was also positive ($\beta = 0.12$) and statistically significant at the 1% level. This suggests a stronger market perception of value for firms with higher ESG ratings.

Further analysis disaggregating the ESG score revealed that the Social and Governance pillars had a slightly stronger individual impact on ROA, while the Environmental pillar was more strongly linked to Tobin's Q, possibly reflecting investor expectations around future environmental regulations and opportunities.

6. FINDINGS

Based on the data analysis, the principal findings of this study are:

- 1) There is a statistically significant and positive relationship between a firm's overall ESG performance and its corporate financial performance.
- 2) This relationship holds for both accounting-based (ROA) and market-based (Tobin's Q) measures of financial performance, indicating that ESG benefits both internal profitability and external market valuation.

- 3) The positive relationship persists even after controlling for firm size, leverage, and industry effects, strengthening the claim of a direct ESG effect.
- 4) All three ESG pillars contribute positively, with Governance and Social factors showing a particularly strong link to operational profitability (ROA), and Environmental performance being highly valued by the market (Tobin's Q).

7. SUGGESTIONS

Based on the findings, the following suggestions are offered:

For Corporate Managers: Integrate ESG considerations into core business strategy and capital allocation decisions. Viewing ESG as a strategic driver for value creation, rather than a compliance burden, can lead to improved financial outcomes.

For Investors: Incorporate ESG metrics into their fundamental and quantitative analysis. The positive link with Tobin's Q suggests that ESG factors contain material information about a company's future risk and return profile.

For Policymakers: Develop clear and consistent reporting standards for ESG disclosures. This will enhance the comparability and reliability of ESG data, allowing for more efficient capital allocation towards sustainable enterprises.

For Future Research: Future studies could explore this relationship in specific sectors (e.g., comparing extractive industries with technology), use a longer time horizon to assess long-term effects, and employ more granular ESG data to pinpoint the most value-creating activities.

CONFLICT OF INTERESTS

None.

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None.

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