Chapter 29

ESG and Financial Performance:

Impact of Environmental, Social, and Governance Issues on Corporate Performance

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ABSTRACT

Non-financial information such as environmental, social, governance (ESG) issues is becoming as much important as financial data. This study investigated the empirical relationship between Thomson Reuters Environmental Social Governance (ESG) Combined Score and performance of S&P 500 firms with eleven years of data from between 2006 and 2016. The study confirmed unidirectional positive and significant relation between ESG Combined Score and ROA, suggesting that improvements in ESG score have positive impact on operating performance of the firm. Although simultaneous equation estimations by means of instrumental variables (IV) employing two-stage least squares (2SLS) and three-stage least squares (3SLS) confirmed the significant positive relation between ESG Combined Score and operational profitability (ROA); contrarily, Tobin's Q seemed to affect ESG score rather than the ESG score inducing Tobin's Q. Higher Tobin's Q seems to lead to a lower ESG score. In other words, firms with higher growth potential as denoted by a higher Tobin's Q, are found to be less sensitive to ESG issues.

INTRODUCTION

The emergence of the recent financial crisis has drawn attention to the companies' attitudes towards risk, ethics, degree of accountability, and capability of managing their stakeholders (Galbreath, 2013). Meanwhile transparency gained importance, investors started to demand timely and accurate informa-

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tion not only in financial but also in non-financial terms. Non-financial information started affecting investment decisions almost as much as financial data. Listed firms that incorporate ESG activities into their strategic agenda and effectively communicate those activities to the investors are offering a more comprehensive picture for corporate valuation. Especially major institutional investors are now taking account of ESG factors in their investment process.

As stated by Daub (2007), the end of 1980s is when first environmental reports were issued, specifically by multinational companies. Socially responsible investing (SRI) which is defined by Kinder (2005) as 'the incorporation of the investor's social or ethical criteria in the investment decision-making process' underscored investors' demand for environmental, social, and governance (ESG) information. As Kinder (2005) expressed, SRI emerged in the UK, Canada, and Australia in the mid-1980s following its appearance in the US in the late 1960s.

Today, different tags are used for investments that consider ESG issues, socially responsible investing to sustainable investing. Some investors practice socially responsible investing merely by avoiding those "sinful" industries like tobacco, gambling, firearms, etc. However, sustainable investing is a more sophisticated approach to investing where risk, return and opportunities are identified with a thorough analysis of ESG issues. Accordingly, many firms are currently utilizing their own resources to generate voluntary ESG reports besides the mandatory ones to better demonstrate their both financial and non-financial performance in line with demand of the investors especially in mature markets.

A thorough measurement of a corporation's performance and its risks can only be achieved by the evaluation of extra-financial reporting in addition to financial results. Assessment of environmental, social, and governance scores are vital for gauging the sustainability of a company's performance and survival (Achim & Borlea, 2015). However, environmental, social, governance issues are expected to affect financial performance in the longer term. Short-term investors are less likely to consider ESG issues in their investment process.

As investors and stakeholders became more aware about non-financial reporting and cared not only about financial results but also societal expectations, resource allocation has also become more complex. Firms are forced to allocate their resources to environmental and social issues as well investing for better financial results and growth. Accordingly, the influence of corporate social performance (CSP) on corporate financial results has been widely probed and discussed (Waddock & Graves, 1997). Su et al. (2016) emphasized that whereas academicians of management documented a positive link between CSR (Corporate Social Responsibility) and financial performance of the firm, those of economics and finance revealed a negative or non-significant relationship. Some leading studies in finance and management literature have exhibited positive results with respect to the influence of CSR on performance and value (Orlitzky, Schmidt, & Rynes, 2003; Margolis & Walsh, 2003). However, negative relationship has also been reported in some other studies (Brammer, Brooks, & Pavelin, 2005). Aupperle et al. (1985) verified a vague link between social responsibility and profitability together with the finding that the intensity of social orientation did not influence the differences in performance. These controversial results can be attributed to the differences in the quantification and measurement of CSR and the selected measures of financial or economic performance.

It is difficult to integrate ESG issues into quantitative models. Because ESG disclosure by companies are generally vague and unstandardized. Besides, ESG issues are expected to impact financial performance in the long term whereas many investment decisions are relatively short-term.

This study attempts to add to literature by investigating the link between ESG combined score taken as the measure for being socially responsible and financial performance with the large dataset of S&P

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