Proceedings of the Decoupling Corporate Finance Implications of Firm Climate Action - ICEMGD 2024
DOI: 10.54254/2754-1169/110/2024ED0084

The Influence of ESG Factors on the Firm Performance

Ziqi Zhang[1,a,*]

[1]Business School, Hohai University, Nanjing, 211100, China
a. 2208020128@hhu.edu.cn
**corresponding author*

Abstract: In the face of escalating global environmental crises, governments worldwide are heightening their expectations for corporate social responsibility, urging businesses to adopt eco-friendly production practices. Consequently, the emergent Environmental, Social, and Governance (ESG) rating system has garnered increasing significance within corporate annual reports. This article undertakes a comprehensive review of prior research examining the correlation between ESG performance and corporate performance. Existing studies have consistently demonstrated the substantial positive impact of ESG performance on enterprises, particularly in terms of bolstering risk management practices and meeting investor expectations. However, there is also evidence indicating a nuanced negative effect on small and medium-sized enterprises (SMEs) due to associated costs. Drawing from a synthesis of these previous findings, this paper delves deeper into the intricacies of this relationship, considering additional factors encompassing management strategies, economic dynamics, and beyond. By expanding our understanding of how ESG performance intersects with firm performance, this study seeks to offer valuable insights for businesses navigating the evolving landscape of corporate responsibility and sustainability.

Keywords: Environmental, Social, and Governance (ESG) Factors, Firm Performance, Small and Medium-Sized Enterprises (SMEs)

1. Introduction

The ESG evaluation system, also known as ESG rating, takes the environment, social responsibility and corporate governance as the core. In recent years, governments around the world have increasingly encouraged companies to disclose ESG reports in their year-end reports. Under such a policy orientation, ESG reports have gradually become a new focus of investors. Therefore, the link between a company's overall performance and its ESG performance has gradually strengthened.

According to the World Economic Forum's Global Risk Report 2022, 80% of the most serious risk types of enterprises worldwide in the next decade are highly correlated with ESG performance, which makes ESG performance gradually become an important factor affecting the financing cost of enterprises, and has attracted wide attention from external investors. In the future, both as individual investors and company management, they need to understand the principle of ESG rating system and its impact mechanism. Since the concept of ESG was put forward, many scholars have studied the relationship between ESG and corporate performance. The existing financing literature is mainly engaged in exploring the positive role of ESG performance in the later stage, some scholars also

© 2024 The Authors. This is an open access article distributed under the terms of the Creative Commons Attribution License 4.0 (https://creativecommons.org/licenses/by/4.0/).

DOI: 10.54254/2754-1169/110/2024ED0084

found that the implementation of ESG increases costs and reduces profits, which has a negative effect on debt financing costs to a certain extent [1].

In existing studies, although both positive and negative impacts of ESG are involved, most scholars study the direct relationship between ESG performance and enterprise performance, and use statistical methods to modeling calculation, without taking into account the mediating effects of management science and investment science, and lack in-depth analysis of each impact factor. The author notes that among the many influencing factors, ESG performance has the most positive impact on enterprise performance in terms of risk management and investor expectations, while it has some negative impact on cost input. Some papers also explain the logical relationship between enterprise performance and the above factors. Therefore, by studying the relationship between ESG performance and enterprise risk management and investor expectations, we can also look at its impact on enterprise performance from a new perspective.

This paper will focus on recent research reports on the relationship between ESG and firm performance, and provide a comprehensive analysis in terms of risk management, investor expectations, and a series of costs incurred by ESG. Through this paper, we hope to effectively summarize the research achievements of current scholars, and establish certain connections among the influencing factors involved in different literature, so that readers can better understand the series of impacts of ESG rating system on enterprises, and inspire future scholars to conduct research from different perspectives.

2. Risk Management

Enterprise risk refers to the uncertainty factors that can affect the realization of an enterprise's strategic objectives and business objectives, including policy risk, market risk, financial risk, business risk and so on. Mature enterprises often have a set of relatively fixed production and operation mode, and sufficient funds also make them more flexible in the face of market changes, so they face smaller business risks and market risks. However, in recent years, with the increasingly severe global climate problems, the laws and regulatory provisions of various governments have responded to this, making many mature enterprises face certain regulatory risks. At the same time, with the unprecedented increase in the transparency of corporate information and the public's expectation of corporate social responsibility in the Internet era, enterprises are facing greater reputational risks. Effective ESG management in corporate reporting can reduce the overall risk of the enterprise, especially in the face of less regulatory risk and reputational risk. For some developing enterprises, ESG performance is also closely related to systemic risk. Foreign studies have found that the impact of ESG performance on the overall performance of enterprises is heterogeneous. For high-risk companies, good ESG performance will reduce more systemic risks. For low-risk companies, more disclosure of ESG information will help reduce systemic risk [2]. It can be seen that investors and the government have higher requirements for ESG reporting of high-risk companies, and only when they show good performance can they reduce risks. For low-risk companies, presenting a clear and transparent ESG report can reduce systemic risk. At the same time, from a stakeholder perspective, good ESG performance helps reduce financial risk. First of all, enterprises promise to actively participate in the construction of the environment and fulfill their social responsibilities, abide by business ethics, and transmit friendly signals to the outside world, which is conducive to maintaining a good relationship with stakeholders, and easy access to customer resources and market information in operation, so as to reduce risks. Secondly, ESG reports further enhance the transparency of information [3]. Stakeholders can have a more comprehensive understanding of the situation of enterprises by viewing the information disclosed by enterprises, which reduces the situation of information asymmetry. On the one hand, it strengthens the regulatory efficiency of enterprises, timely standardizes and restrains the improper behaviors of enterprises, reduces the legal risks of enterprises, and on the other hand,

DOI: 10.54254/2754-1169/110/2024ED0084

improves the transparency of enterprises' operations. Make external investors and industry partners more confident in the company. At the same time, institutional investors themselves pay more attention to national policies and development directions, and rarely appear short-sighted. Therefore, the good ESG performance of enterprises will attract the interest of institutional investors and increase the shareholding proportion of institutional investors. Institutional investors often have the advantage of sufficient and stable funds, and the increase of their shareholding ratio makes the share structure of enterprises more stable. In addition, enterprises with good ESG performance are more popular in the talent market, and it is easier to recruit high-tech talents, improve the development potential of enterprises, and have a positive and negative effect on their ESG performance. Good ESG performance can not only reduce enterprise risks, but also establish brand image and accumulate reputation, transmit good signals to the outside world, and attract new partners and investment.

In recent years, the world's new energy vehicle technology has developed rapidly, the core of the development of new energy vehicle enterprises is technology, the industrial chain on the middle and downstream such as battery materials, battery manufacturing, electronic control motors, vehicle manufacturing, charging piles, etc., have high-tech, high input and high value-added characteristics, enterprise research and development momentum. Due to the environmental strategy introduced by the state in recent years, under the strong incentive of the market and relevant national policies, the power battery, electric driving force assembly and electronic control technology of new energy vehicles in China have made great progress, and are becoming more mature in environmental protection. At present, the state has introduced many policies to build China's ESG system, support enterprises to achieve green technology transformation, for those enterprises that actively fulfill social and environmental responsibilities, the government will give subsidies to them, provide tax incentives to facilitate enterprises to carry out deeper research and development innovation. The ESG performance of new energy vehicles is good, can fully enjoy the dividend of the policy, obtain large subsidies and good reputation, and effectively reduce the financial risk and reputation risk. In addition, the good performance of new energy vehicle ESG is more likely to attract high-quality technical personnel in the market, and high-quality human capital can promote the innovation progress of new energy vehicle enterprises, constantly upgrade product technology to reduce production costs, expand market share, and ultimately improve the competitiveness of enterprises [4]. Good ESG performance also brings other dividends to new energy vehicle companies. Traditional car companies often sell in fixed sales centers, while new energy vehicles, due to their good ESG performance and policy support, can often be advertised and sold in major indoor shopping malls, making their publicity more convenient. At the same time, the state often provides subsidies and benefits for consumers who buy new energy vehicles, indirectly helping new energy vehicle companies to attract customers.

On the other hand, because ESG rating is a relatively new concept and is contrary to the traditional profit maximization corporate goal, it may cause conflicts between shareholders and management in corporate strategic planning, and on the contrary, increase a series of risks of the company. The main business of an enterprise in China is new energy biomass power generation, wind power, hydropower, forestry, sideline for coal mining, with a number of new energy operating power plants in the country, new energy power plants under construction, as well as rich forest resources, there is an affiliated coal mining enterprises. Based on the proposal of China's "double carbon" goal and the maturity of ESG rating system, the enterprise ESG report was disclosed in front of the public. After considering that the company's main business is highly consistent with the national environmental protection policy, the management decided to integrate the ESG concept into the corporate development strategy. The company has set its own strategic goal of clean energy to become a leading enterprise. Under this corporate strategy background, managers and employees must have a strong sense of social responsibility, so that the content involved in the ESG rating system is highly consistent with the corporate strategy. However, profit is an important link to maintain the listed status of an enterprise

DOI: 10.54254/2754-1169/110/2024ED0084

and enhance its market value. In the aspect of corporate listing regulatory law, it emphasizes the profitability of listed enterprises, and if the enterprises start to improve ESG performance, on the one hand, the cost will be increased, and on the other hand, the profitable income of the sideline will be suppressed. At the same time, the background of shareholders of the enterprise is quite different, and the minority shareholders are mostly in the secondary market, which affects the operation and management decisions of the enterprise to a certain extent. Individual investors often have a certain short-sighted problem, and the shareholders of this company do not agree with the ESG concept under the profound influence of the traditional value maximization concept. From the perspective of the "dual carbon" goal, the enterprise needs to control coal mining and coal-fired power generation to achieve the goal of low carbon emissions [5]. When implementing the ESG concept development strategy, the company undoubtedly needs to transform coal-related industries, give up short-term economic profits, invest in research and development funds, and implement the transformation of coal-related industries. Not only that, in the early stage of industrial transformation, enterprises also need to invest a lot of money in research and development, and the research and development of new technologies often has greater risks, once the research and development fails, enterprises will lose a lot of time and funds. More conservative shareholders and individual investors tend to reject such behavior, so the pursuit of ESG performance may lead to conflicts of economic interests at multiple levels and increase risks [6].

3. Investor Expectation

Investor expectations refer to investors' views and expectations on the future development of the market. Investors' expectations are often based on the comprehensive analysis and judgment of many factors such as market economic environment, industry development trend and individual stock fundamentals. The accuracy and rationality of expectations play a crucial role in investors' investment decisions and investment strategies. Investors tend to pay attention to the company information of different enterprises when carrying out expectation management. The information of listed companies consists of financial information and non-financial information. In recent years, non-financial information such as corporate social responsibility and environmental performance has become an important channel for enterprises to transmit non-financial information to the public. When companies are unable to provide high-quality decision information for institutional investors, they can seek other relevant information to provide basis for investment decisions [7]. As a signal, corporate ESG performance conveys the performance of enterprises in environment, social responsibility and corporate governance to the public, and at the same time, corporate ESG performance also conveys risk signals. When ESG information meets the expectations of institutional investors, it can reduce the possibility of implicit or explicit costs and reduce the investment risks of institutional investors [8]. As a result, investors tend to pay more attention to ESG performance reports when comparing different companies with similar financial information. Investors tend to bet more money on companies with better ESG performance. At the same time, investor expectations can be divided into short-term expectations and long-term expectations. Short-term expectations are mainly concerned with market fluctuations and changes in the market, while long-term expectations are more concerned with the analysis of factors such as macroeconomic, industry development and corporate fundamentals. In terms of the larger market share of new energy vehicles and the environmental policies introduced by governments, both short-term and long-term expectations cannot be avoided from the concern about corporate ESG performance.

More and more newly introduced environmental regulations will increase the uncertainty of the business environment of enterprises. Green financial institutions emerging in recent years may pay more attention to the environmental risks and ESG performance of enterprises, and incorporate these factors into the assessment model of enterprise credit risk, so as to better assess the credit risk of

DOI: 10.54254/2754-1169/110/2024ED0084

enterprises [9]. Companies with better ESG performance tend to have lower credit risk and thus lower funding costs. At the same time, the results of the above risk assessment will also guide the flow of capital in the market, so that more funds will flow to enterprises with good ESG performance.

In recent years, many Chinese commercial banks have strengthened the construction of ESG evaluation index system, set up ESG information database, and actively created a lot of rich financial products. These phenomena further lead small and medium-sized investors to put forward higher expectations for the ESG performance of listed companies.

4. Cost-Efficiency

First of all, the development and application of ESG scoring system will put forward higher requirements for the operation and management of enterprises. High ESG performance may require companies to bear more costs and risks, and these additional costs and risks may lead to the decline of the company's profit margin. Individual investors are short-sighted, which could lead to stock price declines. On the other hand, for the sake of their own interests, enterprise managers may ignore ESG investment and improvement in order to achieve some short-term financial goals, resulting in a decline in ESG performance, which violates the expectations of institutional investors and again affects the performance of stock prices. To make matters worse, investors may face information asymmetry when buying corporate shares. If investors do not have enough information to evaluate the true ESG performance of enterprises, they will overestimate the value of these enterprises, causing the stock price to exceed its true value, and giving the managers of the company sufficient incentive to continue to conceal the true information of the company. If ignoring ESG performance does not result in a loss, then managers will continue to misestimate the important role of ESG performance when considering the high costs of ESG. When real ESG ratings are exposed, investors may lose confidence in these companies, leading to a decline in stock prices [10].

Because enterprise managers previously ignored the serious consequences that may be caused by concealing ESG performance, they did not expect and prepare for the stock price decline caused by it, which made the stock price crisis more difficult to deal with and even affected enterprise operation. Other scholars also believe that investors pay more attention to financial indicators when making investments, and ESG evaluation is only a part of the evaluation factor. Implementing ESG and reducing profitability will also make enterprise operators bear too much risk and responsibility. This is the negative offsetting effect that ESG can have on firm performance.

The implementation of ESG requires a large amount of investment to improve the ESG rating level, but investment in research and development has risks. Once the research and development of green products fails or the capital is occupied for too long, the enterprise's circulation is not smooth, which may cause the enterprise to fall into a crisis. Different opinions on the implementation of ESG within enterprises are likely to intensify conflicts between professional managers and enterprise owners [11].

For example, in the third quarter of 2023, the research and development costs of listed green building companies are a large amount of expenditure, and the green research and development costs of China's construction reached 27.758 billion yuan in this quarter, while Shanghai Construction Engineering, ranked second, also invested 7.256 billion yuan. It can be seen that in terms of cost, the pursuit of good ESG performance may make some cash-strapped enterprises face a greater crisis, and even increase the financing cost of equity and debt.

5. Conclusion

In general, ESG rating plays a positive role for enterprises, which is reflected in reducing financial risk, regulatory risk and reputation risk, meeting investors' expectations, and reducing equity financing costs and debt financing costs. Nowadays, with the global warming, resource shortage and

DOI: 10.54254/2754-1169/110/2024ED0084

other problems become increasingly serious, governments of all countries pay more and more attention to the concept of environmental protection. Companies face government regulation and public expectations of environmental responsibility. Only by showing good ESG performance can enterprises reduce regulatory risks and reputational risks. At the same time, with the maturity of the securities market, the participation of institutional investors is getting higher and higher. Since institutional investors are less short-sighted and highly focused on national policies, companies with high ESG performance are more likely to meet their expectations. At the same time, the development of the Internet has made corporate information more open and transparent, and individual investors have certain standards for corporate social responsibility and environmental protection performance. Therefore, only by continuously improving their ESG performance can enterprises absorb more funds in the securities market. However, there is a certain heterogeneity in the positive effect of ESG performance. The effect of ESG is more obvious for enterprises with larger scale and more sufficient capital, while the effect is not particularly significant for small enterprises. Therefore, enterprises should make rational decisions according to their own development strategy and market positioning, and should not blindly pursue ESG performance while ignoring their own profit attributes. At the same time, the ESG rating system has the characteristics of high requirements and comprehensiveness. If companies want to improve their ESG performance, they need to increase their R&D spending on environmental governance and increase their spending on social responsibility. If the company's own funds are insufficient or the research and development results are not consistent with expectations, it may cause negative offset to the performance of the company, triggering a series of chain reactions. Therefore, while responding to the policy call, enterprises should also prudently treat their own strategic planning, fully consider the benefits and costs brought by high ESG performance, and weigh them. At the same time, the whole society should actively advocate the concept of ESG sustainable development, especially the concept of green development, lead financial consumers to actively practice the concept of ESG, obtain investment returns while achieving environmental and social benefits, and promote commercial banks and other financial institutions and influential enterprises to face up to their responsibilities.

References

[1] *Liu, B., & Lu, J. (2024). ESG list on the impact of corporate financing cost alienation effect. Study of Finance and Economics, 1-16.*

[2] *Yu, G., & Song, L. (2019). The impact of ESG performance on financial risk: the moderating effect of digital transformation. Journal of Shanghai Institute of Electrical Engineering, 27(01), 58-62.*

[3] *Gelbds, S., & Strawser, J. A. (2001). Corporate social responsibility and financial disclosures: An alternative explanation for increased disclosure. Journal of Business Ethics, 33(1), 1-13.*

[4] *Qu, X. (2024). ESG performance and enterprise value of new energy automobile enterprises. Economy and Technology, (10), 134-138.*

[5] *Liu, R. (2023). Theoretical framework and application scenarios of the digital transformation of modern enterprise financial management: Review of digital finance: Technology empowerment + Financial sharing + Industry-financial integration + Transformation practice. Journal of Business Economics, (22), 193.*

[6] *Ding, D. (2024). Analysis of financial management strategy of new energy electric power enterprises under ESG concept. Investment and Cooperation, (02), 91-93.*

[7] *Deng, B., Wu, M., & Geely. (2016). Can social responsibility information disclosure attract the attention of institutional investors -- Based on the test of equity capital cost. Science of Finance and Economics, (09), 24-32.*

[8] *Gong, Y. (2022). Study on the impact of corporate ESG performance on institutional investors' shareholding preference, Fujian Agriculture and Forestry University.*

[9] *Xiong, Y., Dai, Y., & Wang, Y. (2024). Green finance and corporate ESG performance: Empirical evidence from Chinese listed companies. Modern Financial Research, 7(02), 22-39.*

[10] *Fu, J. (2024). ESG grading research on the influence of corporate shares. China Business Theory, (5), 165-168.*

[11] *Li, W. (2023). The impact of ESG on corporate financial performance: A case study of Mengniu Dairy. Modern Marketing (Under the Ten-Day), (12), 83-85.*