

e-Proceedings

2024
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**INTERNATIONAL
CONFERENCE
ON ACCOUNTING
& BUSINESS**

Ethics and Integrity in Accounting and Business: Building Trust in an Intricate World

ORGANISED BY:

**FACULTY OF ACCOUNTANCY, UiTM PERAK BRANCH
TAPAH CAMPUS**

In Collaboration With

PROCEEDINGS OF THE 2ND INTERNATIONAL
CONFERENCE ON ACCOUNTING AND BUSINESS

(ICAB2024)

Ethics and Integrity in Accounting and Business: Building Trust in an Intricate World

e ISBN 978-967-2776-35-2

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UNIVERSITI TEKNOLOGI MARA, PERAK BRANCH, TAPAH CAMPUS, MALAYSIA

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Perpustakaan Negara Malaysia

Cataloguing in Publication Data

No e-ISBN: 978-967-2776-35-2

Cover Design: Graphic Design and Web Page Team
Typesetting : ICAB 2024 Proceeding Team

The Relationship Between ESG Performance and Firm Financial Performance

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Abstract

This study investigates the effect of environmental, social, and governance (ESG) performance on financial performance among Malaysian firms. The analysis utilizes comprehensive financial and ESG performance data sourced from the Refinitiv Eikon database, covering a total of 40 firms with 200 firm-year observations spanning from 2019 to 2023. The results reveal a significant positive relationship between ESG performance and financial performance as measured by return on equity (ROE), while the relationship with return on assets (ROA) is not statistically significant. These findings contribute to the existing literature by providing fresh insights into the relationship between ESG performance and financial performance within the Malaysian context, highlighting the specific impact of ESG on equity returns while indicating that asset efficiency may not be immediately influenced by ESG initiatives.

Keywords

Big Four, Financial Performance, ESG, Sustainability Performance, Malaysia

1.0 Introduction

The growth of responsible investment around the world has been fueled by a focus on Environmental, Social, and Governance (ESG) performance, which refers to a firm's non-financial metrics. ESG criteria are used by socially conscious investors to identify socially responsible companies for investment (Chen et al., 2023). The rationale is that stakeholders are more interested in sustainability performance (Zahid et al., 2022). Previous studies indicate that investors reward good ESG firms, while poorly disclosed ESG firms are viewed as indicators of idiosyncratic risks (Mohammad & Wasiuzzaman, 2021). On the other hand, market regulators also include ESG disclosure in their listing criteria, either voluntary or mandatory, to improve financial reporting quality and transparency (Kamaludin et al., 2022). As a result, firms are now increasingly disclosing their ESG performance to meet investor and regulatory requirements. (Hua & Alam, 2021).

The emphasis on environmental, social, and governance (ESG) factors is growing on a global scale. Like every other country intending to export products and attract foreign direct investment, Malaysia has to adjust to meet international standards¹. As an important player in Southeast Asia, Malaysia has witnessed the adoption of ESG frameworks by its authorities, corporations, and government in order to meet both local and global requirements. The Malaysian government, alongside regulatory bodies such as Bursa Malaysia and the Securities Commission Malaysia, has been proactive in encouraging companies to

¹ <https://www.skrine.com/insights/alerts/january-2024/six-global-trends-in-esg-to-watch-out-for-in-malay>

integrate ESG considerations into their operations and disclosures. As part of this effort, Bursa Malaysia launched the FTSE4Good Bursa Malaysia (F4GBM) in December 2014, in collaboration with FTSE Russell, to promote best practice disclosures among publicly traded Malaysian companies. This initiative was further strengthened in 2015 when Bursa Malaysia updated its listing standards to include sustainability-related initiatives. Additionally, in 2018, Bursa Malaysia published a Sustainability Reporting Guide to help Malaysian firms enhance their ESG practices, marking a continued commitment to improving corporate sustainability in the country. However, despite this effort, as of the financial year 2020, only 75 Malaysian companies were involved in ESG reporting, despite market regulators' efforts to promote the practice (The Edge, 2021)². As Malaysia continues to navigate its ESG journey, firms in Malaysia still face significant challenges in sustaining their market positions due to ESG-related issues.

The ESG challenges faced by Malaysian firms, such as the forced labour allegations against Top Glove Corporation and the deforestation concerns with Sime Darby Plantation, highlight significant gaps in ESG reporting and management. These issues have not only damaged their reputations but also resulted in significant financial consequences, highlighting the close relationship between ESG performance and financial performance. Firms that neglect ESG responsibilities often face sanctions, bans, and loss of market access, which can severely impact profitability and long-term sustainability.

In light of these challenges, it is crucial to further explore whether strong ESG performance can positively influence financial performance. This study investigates the relationship between ESG performance and financial outcomes among Malaysian firms, focusing on Return on Assets (ROA) and Return on Equity (ROE). While the research aims to uncover the financial benefits of ESG initiatives, the findings suggest that the impact may vary depending on the specific financial metrics considered. This study provides valuable insights into the complex dynamics between ESG practices and financial performance, contributing to a deeper understanding of how these practices can enhance profitability and promote sustainable business practices in Malaysia.

2.0 Literature Review and Hypothesis Development

2.1 ESG Performance

The term Environmental Social Governance (ESG) refers to a collection of practices or activities that link organizations' to their natural surroundings, their coexistence and interactions with all living things, including humans, animals, and plants, as well as a corporate system of central controls and procedures (i.e., laws, customs, policies, rules, and regulations) to direct and manage organizational issues with the goal of taking into account the interests of all stakeholders (Jamal et al, 2021). ESG performance encompasses three key pillars: Environmental, Social, and Governance. Environmental performance assesses a company's impact on the natural environment, focusing on metrics such as carbon emissions, energy consumption, waste management, and adherence to environmental regulations social performance evaluates how a company manages its relationships with employees, customers, suppliers, and communities, including aspects like labor practices, diversity, and community engagement. Governance performance examines the effectiveness of a company's management structures, including board composition, executive compensation, and transparency. Collectively, these pillars provide a comprehensive view of a company's commitment to ethical practices and sustainable operations.

² <https://theedgemalaysia.com/node/718512>

2.2 ESG Performance and Firm Financial Performance

Numerous studies have investigated the relationship between ESG performance and financial performance, with many finding a positive association. For instance, Xie et al. (2019) explored the connection between specific ESG initiatives and the financial performance of a broad, international sample of firms, concluding that most of these ESG initiatives are positively linked to financial performance. On the other hand, Bhaskaran et al. (2020) used firm value (Tobin's Q) and operational performance (ROE and ROA) as dependent variables to examine the effect of ESG on the financial performance of 4887 enterprises from 2014 to 2018. They show that companies that perform well on social, governance, and environmental fronts typically add greater value to the market. Similarly, Ahmad et al. (2021) analyzed the impact of ESG on the financial performance of 351 FTSE 350 companies from 2002 to 2018, finding that the overall ESG score has a significant and positive effect on financial performance.

However, some researchers have identified negative relationships between ESG performance and financial outcomes. For instance, Landi and Sciarelli (2019) examined 54 publicly listed Italian companies from 2007 to 2015, discovering a negative correlation between their ESG scores and financial performance. Similarly, Duque-Grisales and Aguilera-Caracuel (2021) analyzed 104 multinational firms in Latin America from 2011 to 2015, also reporting a negative relationship between ESG scores and the financial performance of these firms. Consistent with these findings Singh et al. (2022), using a sample of BSE-200 companies and applying multiple regression techniques, found that ESG performance is negatively associated with financial outcomes. In contrast, some studies have reported mixed or no significant effects of ESG performance on financial performance (Giannopoulos et al. (2022); Behl et al. (2022) and Naimy et al. (2021).

The literature review indicates that the results concerning the relationship between ESG performance and financial performance remain inconclusive. Given Malaysia's ongoing challenges with ESG issues, as highlighted previously, further research is essential to clarify this relationship, despite the extensive body of existing studies in the field. Based on these considerations, the following hypothesis is proposed:

H1: ESG performance positively influences the financial performance of Malaysian firms.

3.0 Methodology

3.1 Sample selection

The sample for this study comprises publicly listed firms in Malaysia, selected based on the availability of complete ESG performance scores from 2019 to 2023, as provided by the Refinitiv ESG database. Previous research has demonstrated that Refinitiv ESG data is widely used as a reliable measure of ESG performance (Mohammad & Wasiuzzaman, 2021). The accessibility of ESG data in the Eikon database serves as strong evidence that corporations are actively engaging in ESG and sustainability initiatives.

The process of selecting the final sample involved several steps. First, publicly listed companies (PLCs) in Malaysia, as of December 31, 2023, were identified. Second, a filter was applied in the Refinitiv database to include only those companies with available ESG data. Third, firms lacking complete 5-year ESG data or exhibiting missing information were excluded from the sample. This selection process resulted in a final sample comprising 245 observations across 49 companies.

3.2 Measurement of Variables

The study evaluated firms' financial performance of the selected Malaysian firms using ROA and ROE. These two were used as dependent variables to state the best regression model for evaluating the relationship between the study variables. Return on Asset (ROA) is the ratio of net earnings to total assets, and Return on Equity (ROE) is the measure of a company's annual return (net income) divided by the value of its total shareholders' equity. Both ROA and ROE data of the selected firms will be taken from the Refinitiv Eikon database.

ESG performance is treated as the independent variable. ESG ratings reflect the results of firms' engagement in ESG activities and their subsequent disclosure of ESG-related information. These ESG ratings will be sourced from the Refinitiv Eikon database, and no additional computations will be necessary for the analysis.

This study incorporates several control variables as proposed by the existing literature, including firm size, firm age, financial leverage, and firm risk. Specifically, firm size is measured by the logarithm of total assets; firm age is calculated as the duration from the firm's incorporation to the present; financial leverage is represented by the debt-to-equity ratio; and firm risk is proxied by the firm's beta and weighted average cost of capital (WACC).

4.0 Result and discussion

4.1 Regression analysis

Table 1 presents the relationship between ESG performance and firm financial performance, specifically focusing on ROA and ROE. The Pooled OLS model was used for this analysis due to its statistical robustness in this context. The results indicate that ESG scores have a positive but statistically insignificant impact on ROA (coefficient = 0.048, $p = 0.332$), suggesting that ESG performance does not significantly influence the return on assets.

One potential explanation for this lack of significance is that the benefits of ESG initiatives may require a longer time horizon to materialize. Investments in environmentally friendly technologies or improvements in labor practices often involve substantial upfront costs, such as acquiring new equipment or implementing employee training programs (KPMG, 2022; McKinsey, 2022). These costs can temporarily reduce profitability and diminish the immediate impact on asset efficiency. Over time, however, these initiatives are expected to yield benefits, such as cost savings from lower energy consumption or reduced employee turnover, which could eventually improve ROA (McKinsey, 2022). However, within the timeframe of this study, these longer-term benefits may not have fully manifested, leading to the observed non-significant relationship between ESG performance and ROA.

In contrast, the findings for ROE reveal a significant positive relationship with ESG scores (coefficient = 0.413, $p = 0.000$), indicating that higher ESG performance is strongly associated with increased equity returns among the Malaysian firms studied. This outcome supports the notion that effective ESG practices can enhance shareholder value by improving a firm's profitability relative to its equity. Several studies corroborate this positive association, demonstrating that firms with robust ESG frameworks tend to deliver superior financial performance and attract more investor interest (Triyani et al., 2020; Ghannadighomi et al., 2023). The significant impact on ROE can be attributed to investor perceptions of ESG-compliant

companies as lower-risk and more sustainable in the long term. Such perceptions can lead to increased investor confidence and demand for the company's shares, thereby elevating stock prices and enhancing equity returns. Moreover, strong ESG performance can provide a strategic advantage by aligning firms with global sustainability trends, facilitating access to new markets, and attracting customers who prioritize corporate responsibility. This strategic positioning not only improves the firm's reputation but also contributes to higher revenues and profitability, further bolstering ROE. Hypothesis H1 is therefore partially supported, while ESG performance does not show a significant effect on ROA within the study period, it has a clear and positive impact on ROE.

Table 1: Regression Results - ESG Scores on Firm Financial Performance

Variable	ROA	ROE
ESG Score	0.048 (0.332)	0.413*** (0.000)
Control Variables:		
Total Assets	-5.450*** (0.000)	-17.930*** (0.000)
Firm Age	0.037 (0.396)	0.335*** (0.001)
Leverage	0.007 (0.232)	0.196*** (0.000)
Beta	-7.772*** (0.000)	-30.775*** (0.000)
WACC	2.249*** (0.002)	8.693*** (0.000)
R-squared	0.2525	0.6463

Note: t statistics in parentheses, * p<0.10, ** p<0.05, *** p<0.01

5.0 Conclusion

The significant positive relationship between ESG performance and Return on Equity (ROE) observed in this study can be attributed to several underlying factors. Firms with strong ESG practices are likely to benefit from improved stakeholder relations, enhanced access to capital, and better overall risk management, all of which contribute directly to higher equity returns. In the Malaysian context, where sustainability regulations and investor awareness are increasing, companies that prioritize ESG are better positioned to attract investment and maintain a competitive edge in the market.

In contrast, the lack of a significant relationship between ESG performance and Return on Assets (ROA) suggests that ESG initiatives may not immediately enhance asset efficiency. This finding indicates that while ESG practices might drive improvements in equity returns, they do not necessarily lead to better utilization of a firm's assets in the short term. One possible explanation is that the benefits of ESG practices, such as cost savings from energy efficiency or improved labor relations, may take time to materialize and

impact asset returns. Moreover, some ESG investments may require substantial upfront costs, which could temporarily dampen ROA before yielding longer-term benefits.

The implications of these results are multifaceted. For firms, it suggests that while ESG practices are valuable for enhancing equity performance, they should not expect immediate gains in asset efficiency. This insight is crucial for corporate managers who might be under pressure to show quick financial returns on ESG investments. It emphasizes the need for a long-term perspective when integrating ESG principles into business strategies.

For policymakers, these findings highlight the importance of supporting firms during the transition to sustainable practices. By providing incentives or reducing barriers to ESG investments, policymakers can help ensure that the long-term benefits of ESG practices are realized without negatively impacting short-term financial performance.

For academics, this study contributes to the existing body of literature by providing nuanced evidence from the Malaysian context. It underscores the need for further research to explore why ESG practices might not immediately influence ROA and how these dynamics evolve over time.

For corporate managers, the findings emphasize the strategic value of prioritizing ESG initiatives. While the immediate impact on asset efficiency may be limited, the long-term benefits for equity performance and overall sustainability make ESG integration a critical component of competitive strategy.

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Surat kami : 700-KPK (PRP.UP.1/20/1)

Tarikh : 20 Januari 2023

Prof. Madya Dr. Nur Hisham Ibrahim
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Kelulusan daripada pihak tuan dalam perkara ini amat dihargai.

Sekian, terima kasih.

“BERKHIDMAT UNTUK NEGARA”

Saya yang menjalankan amanah,

Setuju.

27.1.2023

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