International Journal of Research in Commerce and Management Studies

ISSN 2582-2292

Vol. 8, No. 01 Jan; 2026 Page. No. 265-277

To cite this article: Shivani Ram More (2026). EVALUATING THE IMPACT OF ESG ON FINANCIAL PERFORMANCE OF CORPORATIONS, International Journal of Research in Commerce and Management Studies (IJRCMS) 8 (1): 265-277 Article No. 21

EVALUATING THE IMPACT OF ESG ON FINANCIAL PERFORMANCE OF CORPORATIONS

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DOI: https://doi.org/10.38193/IJRCMS.2026.SP8121

ABSTRACT

This study examines the connection between a company's financial performance in a variety of industries and its Environmental, Social, and Governance (ESG) performance. The study examines the impact of ESG scores on important financial metrics like Return on Equity (ROE), Return on Assets (ROA), and Tobin's Q using secondary data from listed companies between 2018 and 2023. The results show a strong positive correlation between corporate financial outcomes and overall ESG performance, suggesting that companies with more robust sustainability strategies typically attain higher profitability and market valuation. Furthermore, the influence of social and governance aspects is greater than that of environmental elements. The findings, which highlight ESG as a strategic driver of long-term competitiveness rather than a compliance need, are consistent with the Stakeholder and Resource-Based theories. The study provides valuable insights for managers, investors, and policymakers promoting sustainable business models that align financial success with corporate responsibility.

KEYWORDS: Environmental, Social, and Governance (ESG), Finance, Financial Performance,

INTRODUCTION

A key tactic for governments to create carbon-free, environmentally friendly, and sustainable financial systems is the use of green finance to reroute funds into sustainable projects as global warming advances (Jin et al. 2024). As a result, shareholder pressure on executives and boards of directors to demonstrate that their companies are run ethically and include green practices into their corporate image has increased (Arduino et al. 2024). In light of the growing shift in investor sentiment regarding these environmentally sensitive issues, stakeholders are becoming more concerned with various aspects of businesses rather than just their turnover. As a result, they prefer to invest in companies that use green practices, operate transparently, and advance equitable society (Sariyer et al. 2024). According to Fiorillo and Santilli (2024), there is a positive relationship between a company's ESG

performance and shareholder objectives, highlighting the necessity of matching investor preferences with corporate sustainability goals. Therefore, the growing importance of environmental, social, and governance (ESG) factors indicates a significant shift in how stakeholders, investors, and the general public view businesses (Rahat and Nguyen 2024). ESG is a crucial criterion for evaluating businesses' dedication to sustainable development and environmental conservation, and it is an extension of corporate social responsibility (CSR) (Niu and Wang 2024). The impact of industry on the environment is addressed by the "E" pillar (Senadheera et al. 2021). The company's impact on the social structures in which it operates is reflected in the "S" dimension (Baid and Jayaraman 2022). The "G" component describes how decision-making authority is distributed across various stakeholder groups inside a company (Lehn 2021). As a result, the ESG idea is a useful tool for reaching the "carbon neutral" goal (Chen et al. 2023). Additionally, a company's ESG performance determines its long-term growth, competitiveness, and overall progress in global sustainable development (Zhang et al. 2024c).

The Principles for Responsible Investment (2017) also promote the inclusion of ESG considerations in the assessment and selection of investments. Furthermore, a networking structure called the Sustainable Stock Exchanges Initiative (2015) assesses how collaborations between legislators, regulators, investors, and businesses may encourage ethical investing for sustainable development (Sustainable Stock Exchanges Initiative 2015). Accordingly, an increasing number of businesses are including ESG elements into their strategy design in order to strengthen their brand, attract investments, and gain a competitive advantage (Xue et al. 2024). Superior ESG performance encourages investment because of advantages like improved reputation, cost savings, and sustainable marketplace access, as demonstrated by Zhang et al. (2024a).

Han and Wu (2024) reaffirmed that greater corporate ESG ratings enhance increasing company value. Furthermore, targets with good ESG performance may help acquirers improve their own ESG performance, which raises market valuations, as demonstrated by Rahman and Wu (2024). Conversely, Duuren et al. (2016) emphasized that a company's capacity to function effectively may be hampered by insufficient social and environmental leadership. For example, Wong and Zhang (2024) contended that investors penalize the stock price of companies with excess cash when divergent opinions about ESG become more pronounced. Similarly, Xue et al. (2023) highlighted that ESG conflicts could negatively impact a company's capacity to invest, perhaps leading to insufficient funding.

Managers and decision makers might benefit from prioritizing sustainability-related projects when allocating corporate finances (Ademi and Klungseth 2022). Therefore, even at the expense of the company's long-term value, people in executive roles see ESG as a dependable investment mechanism

International Journal of Research in Commerce and Management Studies

ISSN 2582-2292

Vol. 8, No. 01 Jan; 2026 Page. No. 265-277

(He et al. 2023). Furthermore, a company's capacity to maximize earnings and achieve sustainability depends on the reduction of business risk (Chen et al. 2024). Therefore, improving ESG performance may successfully lower a company's risk of litigation, according to Zhang et al. (2024b).

RESEARCH OBJECTIVE:

LITERATURE REVIEW

1. The ESG Concept

   There are three main components of ESG:
   Environmental (E): Business initiatives pertaining to waste management, climate resilience, carbon footprint, and resource efficiency.
   Social (S): Human rights, diversity, community involvement, and employee treatment.
   Board composition, openness, moral behavior, and shareholder rights comprise governance (G).
   When combined, these pillars offer a comprehensive assessment of a company's sustainability performance that goes beyond conventional financial measurements.

2. Structure of Theory

   Stakeholder Theory (Freeman, 1984): Makes the case that in order for businesses to succeed over the long term, they must meet the needs of a variety of stakeholders, not just shareholders. ESG activities lower conflict costs and enhance stakeholder interactions.
   According to the Resource-Based View (Barney, 1991), ESG skills can be strategic resources that improve employee loyalty, innovation, and brand reputation, resulting in a long-term competitive advantage.
   Legitimacy Theory: Businesses participate in ESG initiatives to uphold societal legitimacy, which lowers reputational risk and stabilizes revenue flows.
   Trade-off and Agency Theories: Make the argument that because of extra expenses or managerial overinvestment, ESG expenditures may lower short-term profitability.

3. Empirical Proof

   Previous research offers conflicting but overall encouraging evidence: In a meta-analysis of more than 2,000 studies, Friede, Busch, and Bassen (2015) discovered that over 90% of them indicated a positive correlation between ESG and financial performance.

   ESG disclosures boost firm value, especially when they improve transparency, according to Fatemi et al. (2018).

International Journal of Research in Commerce and Management Studies

ISSN 2582-2292

Vol. 8, No. 01 Jan; 2026 Page. No. 265-277

Digital transformation increases the beneficial effects of ESG on firm performance in Chinese listed enterprises, as Fu & Li (2023) showed.
On the other hand, Nollet, Filis, and Mitrokostas (2016) noted that environmental investments may lower short-term profitability because of upfront costs, even while social and governance issues have a beneficial impact on performance.

Overall, research indicates that ESG practices improve long-term financial health, albeit the results vary by sector, geography, and assessment technique.

4. Stakeholders Theory- According to Stakeholder Theory (Freeman, 1984), businesses operate within a network of stakeholders whose satisfaction is essential for long-term success. These stakeholders include investors, employees, consumers, regulators, and communities. By addressing stakeholder expectations, ESG practices improve loyalty and lower transaction costs. Businesses that disregard ESG risk regulatory penalties, consumer boycotts, or reputational damage.

   Resource-Based Perspective (RBV) (Barney, 1991)

   According to RBV, companies can get a competitive edge by utilizing special resources and skills. Sustainable supply chains, green technology innovation, and moral leadership are examples of ESG-oriented behaviors that make up intangible assets that are rare, precious, and challenging to replicate. These assets have the potential to produce better long-term financial returns.

5. According to Legitimacy Theory (Suchman, 1995), businesses should engage in ESG activities to conform to social norms and expectations and preserve their credibility with stakeholders. Businesses that exhibit social responsibility or environmental responsibility win the public's trust and governmental favor, which results in positive financial outcomes.

6. Theory of Signaling (Spence, 1973)

   ESG disclosures give investors encouraging signals about openness and responsible management. As a result, high ESG ratings can draw in investment and lessen knowledge asymmetry, which lowers the cost of debt and equity.

7. Agency and Trade-Off Theories

International Journal of Research in Commerce and Management Studies

ISSN 2582-2292

Vol. 8, No. 01 Jan; 2026 Page. No. 265-277

On the other hand, these theories contend that by taking resources away from core operations, ESG investments may lower short-term profitability. Instead, than maximizing shareholder return, overinvestment in social or environmental programs may be the result of managerial self-interest (Jensen & Meckling, 1976).

8. In a meta-analysis of more than 2,000 research, Friede, Busch, and Bassen (2015) discovered that over 90% of the studies indicated non-negative correlations between ESG and FP, with 63% demonstrating favorable connections. The idea that ESG improves business performance over time is supported by this extensive data.

   ESG disclosures increase firm value by improving transparency and lowering investor uncertainty, according to Fatemi, Glaum, and Kaiser's (2018) analysis of 2,000 European companies. Excessive ESG spending, however, could lower valuation if performance is not disclosed.

   According to Auer and Schuhmacher's (2016) analysis of European equities portfolios, businesses with higher ESG ratings outperform those with lower ESG scores in terms of risk-adjusted returns, especially over the long run.

9. Corporate social performance (CSP) and financial performance were found to be significantly positively correlated by Orlitzky, Schmidt, and Rynes (2003), with reputation and stakeholder trust acting as mediators.

   After reviewing more than 1,000 research published between 2015 and 2020, Whelan, Atz, and Clark (2021) of the NYU Stern Center for Sustainable Business confirmed that ESG integration frequently results in increased financial resilience and reduced capital costs.

   On the other hand, Krüger (2015) pointed out that while positive CSR announcements raise stock prices, negative ESG news results in severe market penalties, indicating that investors are aware of the dangers associated with ESG.

10. New Markets

    Due to varying institutional frameworks, research in emerging markets (such as Asia, Latin America, and Africa) yields inconsistent results.

International Journal of Research in Commerce and Management Studies

ISSN 2582-2292

Vol. 8, No. 01 Jan; 2026 Page. No. 265-277

According to Fu and Li's (2023) research, Chinese A-share listed businesses' financial success is positively impacted by their ESG performance, and this relationship is strengthened by digital transformation.

Stronger ESG engagement lowers the cost of equity, especially in nations with weaker institutions, according to Bae, El Ghoul, and Gong's (2021) study of businesses in 35 emerging markets.

High-sustainability companies have better average sales growth and profit margins, according to Ameer and Othman's (2012) analysis of Asian businesses.

Nawaz and Haniffa (2017), however, pointed out that in South Asian markets, ESG initiatives frequently fulfill compliance objectives and exhibit lower associations with profitability.

11. Developed Economies

ESG typically has a more robust and steady positive correlation with financial results in developed markets.
According to Eccles, Ioannou, and Serafeim (2014), American companies that implement long-term sustainability strategies perform better than their counterparts in accounting and stock market indicators.

According to Clark, Feiner, and Viehs (2015), ESG practices improve operational performance and lower idiosyncratic risk in North American and European businesses.

However, Nollet, Filis, and Mitrokostas (2016) warned that although social and governance aspects improve profitability, environmental interventions may initially reduce short-term returns because of upfront expenses.

Research Gap:

1. Integration of Digital Transformation:

With the rise of data analytics and AI-driven ESG reporting, digital maturity has emerged as a moderating factor in ESG–FP relationships (Fu & Li, 2023). Technology facilitates real-time transparency and stakeholder engagement.

International Journal of Research in Commerce and Management Studies

ISSN 2582-2292

Vol. 8, No. 01 Jan; 2026 Page. No. 265-277

2. ESG Materiality:

   Recent research emphasizes financial materiality, distinguishing between ESG factors that are financially relevant (e.g., carbon emissions in energy) versus those with limited financial relevance (Khan, Serafeim & Yoon, 2016). Firms focusing on material ESG issues realize stronger returns.

3. Greenwashing and ESG Authenticity:

   Growing skepticism surrounds "greenwashing" — superficial ESG reporting without substantive performance. Studies by Delmas & Burbano (2011) warn that inauthentic ESG claims can backfire, eroding trust and valuation.

4. ESG and Risk Management:

   ESG-oriented firms tend to be more resilient during crises. For instance, Albuquerque, Koskinen, & Zhang (2020) found that high-ESG firms experienced smaller stock price declines during the COVID-19 pandemic, suggesting ESG serves as a risk buffer.

5. Regional Policy Differences:

   The strength of the ESG–FP link depends on institutional environments. Countries with stringent ESG regulations (EU, Japan) tend to show stronger positive effects compared to regions with weaker governance or inconsistent disclosure standards.

4.1 Data Source and Description

The study is based on secondary data collected from the Refinitiv ESG Database and Bloomberg Terminal for the period 2018–2023. The sample comprises 200 publicly listed corporations across five industries — Energy, Manufacturing, Financial Services, Technology, and Consumer Goods — drawn from the U.S., Europe, and Asia-Pacific regions.

Each firm's ESG performance score and financial indicators were collected annually. ESG scores range from 0 to 100, where higher values indicate better environmental, social, and governance practices.

Financial performance was measured using three key variables:

- ROA (Return on Assets) – accounting measure of profitability

International Journal of Research in Commerce and Management Studies

ISSN 2582-2292

Vol. 8, No. 01 Jan; 2026 Page. No. 265-277

- ROE (Return on Equity) – shareholder return measure
- Tobin's Q – market-based valuation measure

Control variables include Firm Size (log of total assets), Leverage (Debt-to-Equity ratio), and Sales Growth (%).

4.2 Descriptive Statistics

Variable	Mean	Std. Dev.	Min	Max	Observation
ESG Score	64.85	14.12	25.4	91.8	1,200
ROA (%)	6.74	4.65	-3.2	18.4	1,200
ROE (%)	11.93	9.54	-5.1	35.2	1,200
Tobin's Q	1.92	0.76	0.6	4.1	1,200
Firm Size (log assets)	9.25	0.82	7.5	11.1	1,200
Leverage	0.52	0.21	0.12	0.87	1,200
Sales Growth (%)	7.46	5.84	-3.0	24.7	1,200

Interpretation:

- The average ESG score of 64.85 indicates moderate to strong sustainability engagement among sample firms.
- Average ROA (6.74%) and ROE (11.93%) suggest healthy profitability levels.
- Tobin's Q (1.92) indicates that most firms are valued above their book value, reflecting positive market expectations.
- Moderate leverage (0.52) and steady growth (7.46%) confirm that the firms are financially stable and growing.

4.3 Correlation Analysis

Variables	ESG	ROA	ROE	Tobin's Q	Size	Leverage	Growth
ESG	1	0.48**	0.37**	0.42**	0.25*	-0.15	0.31**
ROA		1	0.69**	0.53**	0.18	-0.45**	0.22*
ROE			1	0.58**	0.12	-0.33**	0.25*
Tobin's Q				1	-0.09	-0.18	0.28*

(*p < 0.05; **p < 0.01)

International Journal of Research in Commerce and Management Studies

ISSN 2582-2292

Vol. 8, No. 01 Jan; 2026 Page. No. 265-277

Interpretation:

- ESG is positively and significantly correlated with all three financial measures (ROA, ROE, Tobin's Q).
- The strongest correlation is between ESG and ROA (r = 0.48), indicating that firms with higher ESG performance tend to achieve better operational profitability.
- The negative correlation between ESG and Leverage (-0.15) implies that high-ESG firms often rely less on debt financing, consistent with prior findings that ESG improves access to equity capital.
- Weak correlation with Firm Size (0.25) suggests that ESG benefits are not limited to large corporations.

Regression Analysis

The following panel regression model was estimated:

$$FP_{it} = \alpha + \beta_1 ESG_{it} + \beta_2 SIZE_{it} + \beta_3 LEV_{it} + \beta_4 GROWTH_{it} + \epsilon_{it}$$

Separate regressions were run for ROA, ROE, and Tobin's Q as dependent variables.

Dependent Variable	ESG Coefficient (β_1)	Std. Error	t-Stat	Significance	R^2
ROA	0.182	0.041	4.42	0.000	0.46
ROE	0.275	0.063	4.37	0.000	0.43
Tobin's Q	0.012	0.004	3.00	0.003	0.39

Interpretation:

- **ESG performance has a statistically significant positive effect on all three financial** performance indicators.
- For every 1-point increase in ESG score, ROA increases by 0.18 percentage points, ROE by 0.27 points, and Tobin's Q by 0.012 units.
- The model explains about 46% of variation in ROA, indicating strong explanatory power.
- These results support the hypothesis that ESG enhances financial performance.
- Control variables behaved as expected: Firm Size had a small positive effect, Leverage had a negative effect, and Growth positively influenced performance.

4.5 Industry-Level Comparison

International Journal of Research in Commerce and Management Studies

ISSN 2582-2292

Vol. 8, No. 01 Jan; 2026 Page. No. 265-277

Industry	Avg ESG Score	Avg ROA (%)	ESG–ROA Correlation
Energy	58.3	5.1	0.41
Manufacturing	61.7	6.3	0.46
Financial Services	68.4	7.8	0.53
Technology	72.1	8.6	0.55
Consumer Goods	65.8	7.1	0.49

Interpretation:

- Technology and Financial Services firms exhibit both higher ESG scores and stronger positive correlations with financial performance.
- Energy firms show lower ESG engagement and weaker profitability linkages, likely due to higher carbon transition costs.
- The trend suggests that ESG investments yield greater financial payoffs in sectors where sustainability aligns closely with innovation and brand reputation.

Trend Analysis (2018–2023)

Year	Mean ESG Score	Mean ROA (%)	Mean Tobin's Q
2018	58.6	5.9	1.71
2019	61.3	6.2	1.78
2020	63.7	6.4	1.80
2021	66.9	7.0	1.95
2022	68.1	7.3	2.01
2023	69.5	7.6	2.08

Interpretation:

- ESG scores steadily increased by about 18% between 2018 and 2023, reflecting growing corporate commitment to sustainability.
- Financial performance improved correspondingly, with ROA rising from 5.9% to 7.6% and Tobin's Q from 1.71 to 2.08.
- This trend supports a positive time-series relationship between ESG performance and profitability, suggesting that long-term ESG integration enhances firm value.

DISCUSSION OF FINDINGS

International Journal of Research in Commerce and Management Studies

ISSN 2582-2292

Vol. 8, No. 01 Jan; 2026 Page. No. 265-277

1. Positive ESG–FP Link:
   The findings confirm that ESG initiatives contribute positively to both accounting-based and market-based financial performance measures.
2. Governance as a Key Driver:
   Among the ESG subcomponents (not shown in the table but analyzed separately), governance had the strongest and most consistent effect on profitability, aligning with studies by Gompers et al. (2003).
3. Long-Term Benefit vs. Short-Term Cost:
   While ESG investments may involve upfront expenses (especially in environmental transformation), their long-term payoff in profitability and valuation is substantial.
4. Cross-Industry Variations:
   ESG–FP effects are strongest in low-emission, innovation-driven sectors (e.g., tech, finance) and weaker in high-emission industries, consistent with Khan, Serafeim & Yoon (2016) on ESG materiality.
5. Theoretical Implications:
   The results validate the Stakeholder Theory and Resource-Based View, suggesting that ESG functions as both a strategic resource and a mechanism for stakeholder alignment.

SUMMARY OF INTERPRETATION

In summary, the data strongly support a positive and statistically significant impact of ESG performance on corporate financial performance across multiple dimensions. Corporations with higher ESG engagement experience:

- Higher profitability (ROA, ROE)
- Greater market valuation (Tobin's Q)
- Improved resilience and investor confidence

These findings highlight that ESG is not merely a compliance exercise but a strategic lever for sustainable financial success.

CONCLUSION:

The purpose of this study was to assess how corporate financial performance across various industries and geographical areas is affected by Environmental, Social, and Governance (ESG) performance. The study discovered a statistically substantial and favorable correlation between ESG participation and important financial performance metrics, including Return on Assets (ROA), Return on Equity (ROE), and Tobin's Q, using quantitative analysis of secondary data (2018–2023) from 200 listed corporations.

International Journal of Research in Commerce and Management Studies

ISSN 2582-2292

Vol. 8, No. 01 Jan; 2026 Page. No. 265-277

The findings show that companies with larger ESG commitments typically see increases in market valuation, profitability, and operational effectiveness. This result supports the main ideas of the Resource-Based View and the Stakeholder Theory, both of which highlight the strategic significance of sustainable and socially conscious company operations. Businesses that actively manage their environmental impact, respect moral governance principles, and interact positively with stakeholders are rewarded with stable finances and the trust of investors.

Comparisons at the industry level showed that ESG effects are particularly noticeable in financial services and technology, where sustainability is directly related to innovation, transparency, and brand reputation. On the other hand, because of their high transition and compliance costs, resource-intensive industries like manufacturing and energy exhibit slower ESG-related payoffs. These differences highlight how crucial industry context and ESG materiality are in determining financial results.

Over the course of the study, trend analysis showed a consistent rise in ESG performance and profitability, particularly after 2020, indicating that sustainable practices support business resilience in erratic markets. Additionally, the findings support growing worldwide evidence that ESG serves as a risk management tool, shielding businesses from operational and reputational shocks

The study does, however, admit certain limitations, such as the use of secondary data and possible variations in ESG rating systems between databases. To fully understand the subtleties of ESG integration and its dynamic effects on business value, future study might use primary data, qualitative insights, and sector-specific models.

In conclusion, there is compelling evidence that ESG is a long-term investment that boosts shareholder value and organizational competitiveness rather than a financial burden. In an increasingly open and stakeholder-driven corporate climate, companies that integrate sustainability into their fundamental strategies are more likely to see sustainable financial development, draw in ethical investors, and maintain their credibility.

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