

ESG Disclosure and Firm Performance

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Contributor: Silvia Carnini Pulino , Mirella Ciaburri , Barbara Sveva Magnanelli , Luigi Nasta

The information on corporate non-financial practices can be summarized through the “three modern pillars” of Corporate Social Responsibility (CSR), which are the Environmental, Social, and Governance (ESG) pillars representing a measure of the CSR performance of a firm.

ESG

sustainability

signaling theory

1. Introduction

A rising level of activism and commitment towards the environmental, social, and governance practices has led to increased firm engagement in socially responsible practices, and consequently to greater firm disclosure about such practices to enhance awareness among stakeholders.

In Europe, disclosure has been further encouraged by Directive 2014/95/EU (the Directive), which has required large companies—those with more than 500 employees—to annually disclose information about their non-financial practices, policies, and outcomes as well as anti-corruption strategies and procedures they have adopted. Further development of this Directive, the Corporate Sustainability Reporting Directive (CSRD), took place on 21 April 2021, amending the existing reporting requirements of Directive 2014/95/EU, supported by the increasing need for sustainability disclosure.

The information on corporate non-financial practices can be summarized through the “three modern pillars” of Corporate Social Responsibility (CSR) ^[1], which are the Environmental, Social, and Governance (ESG) pillars representing a measure of the CSR performance of a firm ^{[2][3][4][5]}. The CSR performance can be measured using the ESG score, which is considered a proxy for the firm results on CSR practices ^{[6][7]} because it provides the most objective measure available at the time of writing. In fact, the ESG score is intended to objectively and clearly evaluate the ESG performance, considering the bundle of environmental and social activities of CSR, together with the corporate governance activities ^{[8][9][10]}.

The fundamental question that still needs to be addressed in greater depth is whether ESG disclosure does lead to better performance for the firm. Given that no unique findings on this relationship have been achieved yet, addressing this issue is particularly relevant not only for firms, which survive when they perform well, but also for stakeholders, such as investors, suppliers, and customers, who rely on the firm for their survival as well. Acting within the Agency and Signaling theory framework, the aim of this research is to understand the specific impact of ESG disclosure and of the three pillars on the performance of the firm, considering both the income statement

perspective and the assets perspective, in order to fill a gap in the literature, which focuses primarily on the market value of the firm and the whole performance of the firm often measured by ratios, such as the ROE. The focus of this research on the firm performance enables to directly link ESG disclosure to what is currently happening in the firm at the business level, independently of any additional effects dictated by capital structure, taxes, or market expectations ^{[11][12]}. Considering not only the ESG score as a whole but also its single pillars is meaningful because each component might have a different but relevant (or not relevant) impact on the performance of the firm. The research focuses on one single country, Italy, where the Legislative Decree 254/2016 implemented the Directive, obliging the largest firms to disclose comprehensive information about their social and environmental activities. The relevance of this new law relies on the fact that this is the first regulation for listed firms about non-financial information disclosure. Even if the Italian corporate market is characterized by a consistent number of small and medium enterprises, this law nowadays is mandatory only for the largest firms, as before mentioned.

2. ESG Disclosure and Firm Performance

In recent years, the concept of ESG disclosure has become a hot topic not only for academia but also for practitioners and international standard-setters ^{[13][14][15]}. Among all the studies, a great part of the extant literature has focused on the impact of ESG disclosure on the firm performance or on how a single pillar of the ESG affects the firm performance ^{[3][16][17]}. It is important to highlight that the largest part of the literature focuses on the overall ESG score, without analyzing the single ESG pillars. Each pillar may impact the firm in a different way and with a different intensity. For example, Cek and Eyupoglu ^[18] show that the social and governance pillars positively and significantly impact the firm's economic performance mainly because of the value generated for the shareholders in the long run. On the same path, Paolone et al. ^[7] find that the governance pillar effect is much stronger than that of the other two pillars on the market performance of a firm. Nevertheless, ESG pillars are connected to each other, thus focusing on a single one can be reductive. Some researchers have investigated the three pillars of the ESG and their impact on firm performance at the same time ^{[4][19][20][21][22][23]}, without coming to a unified view; rather, the research highlights the fact that different contexts may present different scenarios with different characteristics that influence both firm performance and ESG practices. Thus, it appears that the collective understanding of the relationship between ESG disclosure and firm performance would benefit from an approach that looks not only at the impact of the ESG score as a whole, but also (i) takes into account the impact of the individual pillars, and (ii) focuses on a single context, such as a single industry or a single country ^{[24][25][26]}. Lastly, the literature appears not to have emphasized the role of the ESG on the operating aspect of the performance, such as the effects on the income statement figures and on the return coming from the investments made for the business activities.

As far as specific contexts are concerned, what emerges looking at previous studies focusing on the relationship between the ESG and the firm performance, is that there is a lack of systematization in the literature covering the European and Italian contexts, producing findings that are not univocally aligned; in Italy, specifically, this may be partially due to the fact that the Directive on disclosure began to be implemented only in 2016. Most studies cover the relationship between disclosure and financial performance and market value, and some explore the impact of ESG performance on the cost of capital and credit ratings, while works that focus on firm performance or analyze

the individual pillars are scant and very specific to single sectors or aspects so that a complete picture has not yet fully emerged.

The scarce focus on the firm performance tested through accounting-based measures, together with the lack of alignment of the results, is apparent even in more extensive studies covering several years of data. For instance, in their work covering five years of panel data from G7 countries, Almeyda and Darmansya [27] highlight the correlation between ESG disclosure and firm performance measured through ROA and ROC (significant correlation), as well as between ESG disclosure and market value measured through stock price and price-to-earnings ratio (no significant correlation); moreover, while they do look at the individual pillars, the environmental pillar appears to have a positive relationship with both ROC and stock price, while the social and the governance factors do not appear to have a significant relationship. Similarly, an extensive study of the Eurostoxx50 index covering 9 years, focuses on market value, confirming the absence of a relationship between companies' market value and their ESG efforts [28], a conclusion mirrored by an analysis of Italian listed companies [29]. However, these findings are contrasted with a later study of the value relevance of disclosure in the same context [7].

A greater focus on firm performance is found in the Italian context, where a study of 84 newly listed Italian companies over a seven-year period shows a significant impact of ESG on ROA, primarily explained by the environmental score [30]. However, when looking at specific sectors, significant disparities arise. In banking, for instance, overall ESG performance is shown to have a significant impact on both the financial and market performance, measured through ROA, ROE, and Tobin's Q; however, when measured individually, the social pillar is found to negatively affect all three measures, while the governance component negatively affects ROA and ROE and positively affects Tobin's Q [31]. In the Italian pharmaceutical industry, on the other hand, the governance pillar appears to have a strong positive influence on its financial performance [7].

Even when looking at apparently consolidated findings, disparities may arise. For instance, there appears to be a consensus that a positive assessment of ESG strategy has an impact on credit ratings [32], the cost of capital, and especially the cost of debt, giving virtuous companies access to debt at better conditions [33][34]; social and governance pillars drive the correlation [35]. When the analysis concentrates on non-family-run small and medium-sized enterprises (SMEs), it shows that environmental disclosure actually leads to an increase in the cost of capital [36]. This supports the idea that in order to have a complete picture of the relationship between ESG disclosure and firm performance, a sector-by-sector analysis is required.

Other developing areas of research involve the factors that lead to ESG disclosure, such as board composition, as well as the impact of the quality of ESG information [37]. In Italy, Provasi and Harasheh conducted extensive research into gender and board composition, finding that while female involvement has no significant impact on performance, it does appear to lead to higher ethical scores [38]. Cucari et al. [39] explored the relationship between the board of directors' diversity and ESG disclosure, finding that the greatest positive correlation happens between board independence and ESG, while, interestingly, a greater presence of women on the board has a negative correlation with ESG disclosure [40]. At the European level, however, Nicolò et al. [41] find that the presence of women on boards enhances ESG disclosure; the disparity in findings may be explained by the concept of a critical

mass of women on boards ^[42], though this does not appear to apply across sectors, as illustrated by the banking domain ^[43]. With regards to the quality of the ESG information disclosed and the impact that the credibility of such information has on firm performance and market value, in Italy the assurance of the quality of the information does not appear to lead to an incremental benefit, perhaps because the market perception of quality assurance is still in its infancy ^[44]; the findings in this area suggest that there is a lack of homogeneity in disclosure requirements ^[45] and that third party auditing would be beneficial to ESG score reliability ^[46]. Equally, there is no evidence to suggest that mandatory over voluntary disclosure has led to the incremental value of the firm ^[47]; even though at the global level, investors increasingly believe that ESG ratings provide information that is material to the performance of the investment ^[48], recent research in Italy suggests that there is not a homogeneous corporate response to ESG rating requirements ^[49].

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