Corporate Financial Performance in the Wake of ESG Controversies: The Indian Firm Context

Mannu Dutt[1], Riidhi Jain[2], Dr. Dipasha Sharma[3] and Dr. Sonali Bhattacharya[4]

Abstract

This study investigates the influence of ESG disclosure scores and ESG controversies scores on the financial performance of NSE 500 companies from 2020 to 2024. The analysis focuses on key financial metrics, including Return on Assets (ROA), Return on Equity (ROE), Price-to-Earnings (PE) ratio, and Tobin's Q. The results indicate a significant positive relationship between ESG disclosure scores and both ROA and ROE, suggesting that transparent ESG reporting enhances organisational efficiency and financial outcomes. These findings align with Freeman's Stakeholder Theory (1984) and earlier studies of Kumari et al. (2022), which posits that engaging stakeholders through transparent ESG disclosures improves financial results.

The results carry important implications for both corporate managers and investors. For managers, the positive association between ESG disclosure scores and financial performance highlights the importance of transparency in ESG reporting. While ESG controversies may not have immediate financial effects for investors, they could harm long-term financial performance and corporate reputation. By examining the dual role of ESG disclosure and controversy scores, this study seeks to provide valuable insights for corporate managers and investors, emphasising the critical importance of

[1] mannu_dutt@scmhrd.edu. Symbiosis Centre for Management and Human Resource Development, Symbiosis International (Deemed) University, Pune, India

[2] ridhs1996@gmail.com .Affiliation 1 - Dr. D. Y. Patil B School, Pune, India.
Affiliation 2- Symbiosis Centre for Management and Human Resource Development, Symbiosis International (Deemed) University, Pune, India

[3] dipashasharma20@gmail.com, dipasha_sharma@scmhrd.edu
Symbiosis Centre for Management and Human Resource Development, Symbiosis International (Deemed) University, Pune, India

[4] sonali_bhattacharya@scmhrd.edu
Symbiosis Centre for Management and Human Resource Development, Symbiosis International (Deemed) University, Pune, India.

transparency and ethical conduct in enhancing organisational trust and financial outcomes.

Keywords: ESG disclosure scores, ESG controversies, Financial performance, Corporate reputation, India

Introduction

In recent years, academicians, professionals, and policymakers have increasingly emphasised achieving Sustainable Development Goals (SDGs) within corporate environments. This shift has contributed to improving and refining Environmental, Social, and Governance (ESG) metrics (Agnese et al., 2024). ESG is integral to the Principles for Responsible Investment, which align with the United Nations' Sustainable Development Goals (United Nations, 2006). The growing significance of ESG factors has also reshaped how investors and corporations assess their long-term profitability.

An organisation's performance is now assessed by its financial results (Fung, 2014; Jo & Harjoto, 2012) and by its contributions to ESG factors. These include environmental sustainability, societal welfare, and the quality of its governance (Henisz et al., 2019; Yu & Zhao, 2015). Together, these ESG factors form ESG scores, which indicate how effectively the organisation manages these critical areas.

As Socially Responsible Investing (SRI) aligns with the UN's Sustainable Development Goals (SDGs), it highlights how investment decision-making integrates environmental, social, and ethical considerations (Gangi et al., 2022; Suttipun, 2021; Kumar et al., 2022; Sharma et al., 2020; Revelli, 2017; Sandberg et al., 2009). In recent years, SRI has grown significantly in both importance and popularity (Dervi et al., 2022; Jaiswal et al., 2024). The CFA Institute (2020) notes that ESG investing has transitioned from being a niche approach for ethically minded investors to becoming a standardised practice (Adams & Abhayawansa, 2022). With ESG scores now a key factor in investment decisions, there is growing recognition that sustainability factors directly influence the trading behaviour of both individual and institutional investors. Institutional investors, in particular, tend to be more responsive to ESG-related controversies (Bang et al., 2023).

ESG scores may not entirely reflect an organisation's overall sustainability performance, but a high ESG score does suggest effective management of ESG factors. However, these scores do not account for ESG controversy scores, which can significantly impact financial performance. ESG controversies often involve actions that violate stakeholder rights (Strike et al., 2006). When an organization is repeatedly involved in such controversies, its viability and trust are undermined, leading to negative repercussions on its ESG activities and overall reputation (Dasgupta, 2022; Sensharma et al., 2022).

The study explores the relationship between ESG disclosure scores, ESG controversy scores, and the financial performance of NSE 500-listed companies for 2020–2024. Data has been sourced from Prowess IQ and Bloomberg. The research specifically focuses on NSE 500 companies, excluding banking and financial institutions, as these firms follow distinct accounting practices compared to other sectors (Kim et al., 2018). The study employs panel data regression to analyse the association between ESG factors and the financial performance of NSE 500 companies.

Literature Review

Corporate Social Responsibilities (CSR) have become imperative for businesses to undertake such CSR initiatives to inflate their competitiveness, comply with the regulatory and legal requirements of their home country, enhance their reputations among the stakeholders, and adhere to established corporate values (Campbell, 2007; Del Giudice et al., 2017). There has been an increase in the number of researchers interested in examining how sustainable practices improve the financial performance of companies and provide value to various associated stakeholders (Fiandrino et al., 2019; Li et al., 2019).

Freeman (1984) introduced the stakeholder theory to the world, which presents that organizations should work towards achieving more than just the needs and demands of the shareholders but must also take into consideration the more comprehensive selection of stakeholders, which includes their employees, their customers and their communities at large. For these organizations, getting involved in CSR activities is an approach to handling their stakeholders. Consequently, organizations build more resilient associations with them, leading to a much enhanced outcome in the operational zone. Finding and maintaining equilibrium with the stakeholders has become even more crucial as businesses everywhere are scrutinized more closely, especially regarding their societal and environmental impacts. Organizations involved in ESG-related responsible activities earn their stakeholders' faith and commitment, improving their overall competence, efficiency and innovation (Henisz et al., 2019).

The literature provides evidence of the benefits of CSR and ESG on firm performance, including financial performance, corporate reputation, and innovation (Ghouri et al., 2019; Hernandez et al., 2020). However, the literature on the effect of CSR activities on financial performance proves to be complex, as some researchers found negative or insignificant effects (Kim et al., 2018).

An extensive collection of research has now studied the effect of ESG-related news on the financial markets (Capelle-Blancard et al., 2021). The research includes examining the accidents (Bowen et al., 1983; Hill & Schneeweis, 1983; Borenstein & Zimmerman, 1988), studies done on regulation (Gilley et al., 2000; Jacobs et al., 2010; Karpoff & Lott, 1993), and events related CSR activities (Flammer, 2013; Krüger, 2015; Capelle-Blancard & Petit, 2019; Farber & Hallock, 2009). The outcomes of these studies showcased that negative ESG news was severely impacted by the shareholders, whereas the positive news had a marginal gain (Nicolas et al., 2023).

While several studies are done examining the effect of ESG strategies on financial performance, they show different levels of results, being either positive, negative, or mixed (Behl et al., 2022; McWilliams et al., 2006). But in reality, the relationship shared by the financial performance of organizations and ESG strategies and related news is much more complex than a cause-effect relationship, and several factors must be taken into consideration in order to study the impact of one variable on another (Nirino et al., 2020).

In the case of ESG-related activities, it becomes imperative that organizations standardize their operations with the existing traditional conventions and customs in order to secure and preserve their legitimacy, as was proposed in legitimacy theory by Suchman (1995). In today's world, organizations that choose to report their ESG activities or abide by the sustainability principles showcase themselves in compliance with societal conventions, and they end up improving their legitimacy status, which has a positive impact on their corporate standing, shareholders' confidence and their financial performance (Aouadi & Marsat, 2018). Whereas, when organizations are involved in ESG-related scandals or controversies, they violate societal conventions, they encounter notable threats to their reputation, which in turn affects their financial performance, that is, their profitability, to be more precise, as shown by the literature (Walsh et al., 2009).

The legitimacy theory sheds light on why organizations with high levels of ESG disclosure scores can sustain societal validation, hence decreasing their chances of getting into fiscal repercussions and losing the confidence of their investors. On the other hand, organizations that do not comply with societal conventions or regularly have to endure ESG-related controversies get unfavourable financial results and lose their legitimacy. The legitimacy theory contributes to shedding light on the multi-layered relationships shared by an organization's reputation, its compliance with societal conventions and the effect it has on the organization's financial performance in the long run.

Looking from a different perspective of the increase in global warming and pollution issues, it becomes necessary for corporations to change the way they run their business. It seems rational to make policies and take actions to safeguard the environment and the community, but still, companies do not always comply with such rules and regulations. As pointed out by (Walsh et al., 2009) states that scandals and controversies can potentially imperil the corporate reputation and thus impair the company's performance. However, the concept of corporate controversy and its connection to CSR has been neglected in the literature. Further, there is a need to address how corporate scandals affect the firm's association between ESG controversies and ESG performance on the corporate financial performance of Indian firms.

Research Design

Data Collection

The study focuses on NSE 500 listed companies for the period of 2020-2024. The data has been extracted using Prowess IQ, Bloomberg terminal and Refinitiv Eikon. The research focuses on NSE 500 companies, excluding the banking and financial institutions, as financial firms follow different accounting schemes in comparison to other sectors (Kim et al., 2018). Based on the availability of data on ESG scores, a sample of 64 companies was selected to study the relationship between financial performance and ESG scores and the ESG controversy.

Variables and specified model

The independent variables of the study are the ESG disclosure score (Naeem et al., 2022) and the ESG controversies score (Nirino et al., 2021). Whereas firm financial performance is the dependent variable (Nirino et al., 2021), which is measured through Return on Assets (ROA), Return to Equity (ROE), and market performance through Price-Earnings ratio (PE) and Tobin’s Q. To control the firm characteristics some control variables are also introduced such as firm size (in terms of natural log of total assets), firm age, firm liquidity (in terms of current ratio), and financial leverage (Doshi et al., 2024).

Table 1: Description of Variables

Variables		
Dependent variable	ROA	Return to assets
Dependent variable	ROE	Return to equity
Dependent variable	PE ratio	Price-earnings ratio
Dependent variable	Tobin's Q	Market capitalization + Total liabilities/ Total assets
Independent variable	ESG score	Environmental, social and governance score
Independent variable	ESG C	ESG controversy score
Control Variable	FL	Financial leverage
Control Variable	Log TA	Natural logarithm of total assets
Control Variable	Age	Year of data obtained- Year of incorporation
Control Variable	Liq	Firm liquidity (Current Assets - Current liabilities)

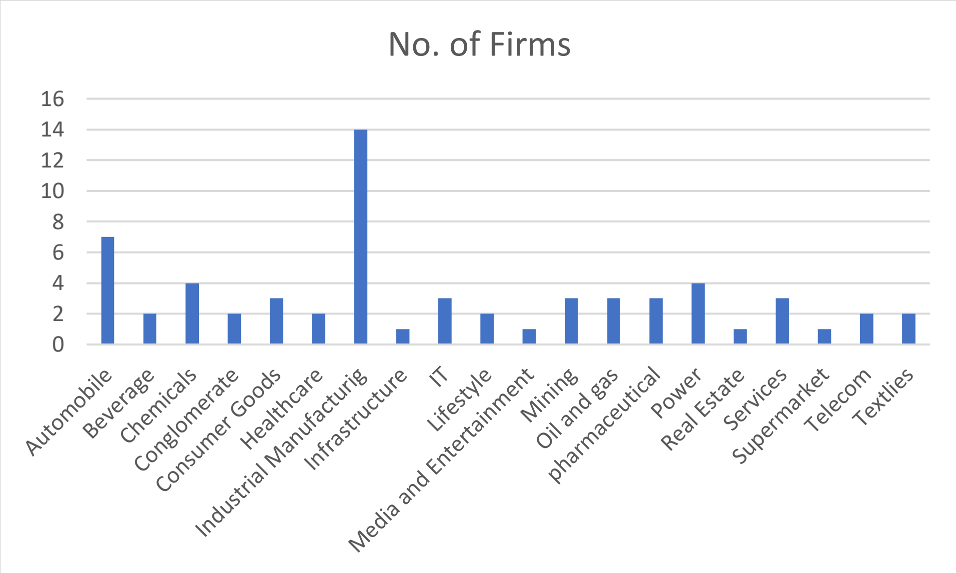
Equation- $$Financial\ Performance\ (ROA, ROE, PE, Tobin\ Q) = \alpha + \beta 1\ ESG\ scoreit + \beta 2\ ESG\ controversy\ scoreit + \beta 3\ log\ Total\ assets\ it + \beta 4\ Firm\ age\ it + \beta 5\ Financial\ leverage\ it + \beta 6\ Firm\ liquidity\ it + \boldsymbol{\varepsilon}$$

The ROA, ROE, PE ratio, and Tobin's Q measuring the financial performance of the sample forms are the dependent variables. Further, (α) is the constant, and (β1: β6) are the parameters of the independent variables. The ESG disclosure score and the ESG controversy score are the independent variables in the model. Log of total assets, firm age, financial leverage, and firm liquidity are the control variables of the study.

Data Analysis

Descriptive Statistics

Figure 1: Description of firms in data



Source: Authors' calculation

Figure 1 shows the number of firms from different industry sectors included in the study. The majority of firms belong to the manufacturing sector, while infrastructure, media and entertainment, real estate, and supermarkets have the lowest number of firms in the sample.

Correlation Matrix

	ROA	ROE	Tobin Q	PE	ESG score	ESG contro	Age	Log TA	FL	F liq
ROA	1									
ROE	0.408 **	1								
Tobin Q	0.001	0.010	1							
PE	0.16	- 0.013	0.059	1						

ESG score	0.119*	0.183**	0.025	-0.093	1					
ESG contro	0.071	0.031	0.024	0.070	-0.201**	1				
Age	0.071	0.00	-0.047	0.067	0.048	-0.085	1			
Log TA	-0.176**	-0.009	0.019	-.328**	0.243**	-.343**	-0.033	1		
FL	0.380**	0.071	0.034	0.048	-0.115*	0.081	0.068	-.328**	1	
F liq	-0.402**	-0.091	0.066	0.078	-0.009	-0.0669	-0.158**	0.171	-0.228**	1

Source- Authors; calculation

*** Correlation is significant at the 0.01 level (2-tailed), * Correlation is significant at the 0.05 level (2-tailed)*

Note: ROA- Return on assets, ROE- Return on equity, PE- price earning ratio, ESG contro- ESG controversy score, Age- firm age, log TA- natural logarithm of total assets, FL- financial leverage, F liq- firm liquidity

Table 2 shows the correlation between the variables. As per Gujarati et al. (2003), a correlation coefficient of more than 0.8 shows multicollinearity. The correlation values indicate that the independent variables are less than 0.8, thus eliminating the possibility of multicollinearity. The dependent variable ROA positively correlates with the ESG score (0.119), which is significant at 0.05 level, and there is no correlation with the ESG controversy score (0.071). Further, ROE also has a positive correlation with the ESG score (0.183), which is significant at 0.01 level, and no correlation with the ESG controversy score (0.031). Tobin's Q has no correlation with the ESG score and ESG controversy score (0.025, 0.024), respectively. Lastly, another dependent variable, the PE ratio, also has no significant correlation between the ESG score and ESG controversy score (-0.093, 0.070), respectively.

Multicollinearity Test

The study adopts VIF (variance inflation factors) to check for multicollinearity of data before conducting the regression analysis. The results show the values in the acceptable range, VIF <10; thus, no multicollinearity was found in the data (Altaf et al., 2022).

Panel Data Regression Results-

The study uses Panel data regression to test the research hypothesis. This technique is often used in financial and management studies to analyse the impact of sustainability initiatives on the performance of firms (Nirino et al., 2019). To analyse the impact of ESG disclosure scores and ESG controversy scores on the financial performance of the company, the study develops four different models (Table 3). Model 1 and 2 are based on financial performance of the firm (ROA, ROE) and model 3 and 4 are based on the market performance of the firm (PE ratio, Tobin's Q).

	ROA		ROE		PE		Tobin Q	
	Coefficient	P-value	Coefficient	P-value	Coefficient	P value	Coefficient	P-value
Constant	5.33	0.30	-16.46	0.47	2.47	0.00*	2.38	0.00*
ESG	0.087	0.00*	0.35	0.002*	0.05	0.74	-0.009	0.01*
ESG C	0.01	0.25	0.06	0.15	-0.10	0.32	0.00	0.36
LOG TA	-0.32	0.39	0.47	0.75	-16.55	0.00*	-0.03	0.00*
Age	-0.01	0.01*	-0.01	0.56	0.10	0.24	0.004	0.00*
FL	-2.27	0.00*	-2.24	0.37	15.18	0.14	0.00	0.38
F liq	1.68	0.00*	2.14	0.12	-1.59	0.52	0.004	0.35
R-sq	28.40		5.61		15.77		26.61	

Source- Authors' calculation
Note: significance at 0.05% level
ESG C- ESG controversy score, Log TA- log of total assets, Log Emp- log of total employees, FL- financial leverage, ROA- return on assets, ROE- return on equity, PE- price to earnings ratio

As per the above table, ROA, ROE, PE, and Tobin Q are the dependent variables. ESG disclosure score and ESG controversy are the independent variables, and the log of total assets, firm age, financial leverage, and firm liquidity are the control variables of the study. The result shows that for model 1, the ESG score has a positive and significant impact on ROA. financial performance through ROA (β= 0.087, P value- 0.00), whereas the ESG controversy score was found to be insignificant (β= 0.01, P value 0.25). The R-square value of 0.284 shows that 28.4% variation in the ROA is explained by the model. Discussing the results of model 2, ESG score has a positive and significant impact on ROE (β= 0.35, P value- 0.002), and ESG controversy is found to be insignificant for (β=0.06, P-value= 0.15). The R-square value of 0.0561 shows that only 5.61% of the variation in ROE is explained by the above model. Further, the results of model 3, ESG score and ESG controversy were found to be insignificant for PE (β= 0.05, P value- 0.74; β= -0.10, P-value= 0.32), respectively. The R-square value of 0.1577, shows that 15.77% variation in the PE ratio is explained by the variables adopted in the study. Lastly, discussing the results of model 4, the ESG score was found to be negatively significant for Tobin's Q (β= -0.009, P value- 0.01) and insignificant for the ESG controversy score (β= 0.00, P value- 0.36). The R-square value of 0.2661, shows that 26.61% variation in the Tobin's Q is explained by the variables adopted in the study.

Discussion

The relationship shared by ESG disclosure scores, ESG controversy scores, and the financial performances of Nifty 500 companies between the years 2020 and 2024 has been explored in this study. The study's analysis explicitly examined Return on Assets, Return on Equity, Price to Equity Ratio and Tobin's Q with respect to the ESG Disclosure and ESG controversy scores respectively.

The results of this study showcased that a positive and significant relationship is shared by ESG disclosure scores, Return on Assets and Return on Equity, which signifies that the organizations with enhanced levels of transparency and accountability of their ESG-related activities have a tendency to do better when it comes to their proficiency and financial performance. These findings corroborate similar studies done by Henisz et al. (2019) and Lopez-de-Silanes et al. (2020) that revealed that higher levels of transparency in ESG-related activities end up with reduced levels of risk and enhanced financial performance and stakeholder confidence. These findings are further corroborated by Freeman's Stakeholder theory (1984), which highlights that organizations that are heavily involved with their stakeholders with the help of explicit ESG reporting tend to have higher ROA and ROE as a result of improved levels of efficiency.

In spite of the positive relationship between ROA and ROE, the same being insignificant for the PE ratio reflects that ESG transparency may not directly influence the profitability and market valuation of an organisation. These findings furthermore corroborate similar studies that revealed that even though ESG transparency strengthened an organisation's operational performance, it ultimately did not have any effect on PE levels (Almeyda & Darmansya, 2019).

Furthermore, the ESG disclosure score was found to have a negatively significant relationship with Tobin’s Q indicating that improved levels of ESG related disclosures may have a negative effect on the market capitalisation of the organisation. This is in line with the results of McWilliams et al. (2006), which found that an organisation's market valuation may suffer because of the stakeholders' comprehension of the transparency as an indication of upcoming liabilities or financial burdens.

In contrast to ESG disclosure scores, the analysis goes on to demonstrate that ESG controversy score has no significant impact towards ROA, ROE, PE ratio and Tobin’s Q, implying that ESG-related controversies don't have any effect on the organisation's proficiency and market capitalisation. These findings corroborate the findings of Aouadi & Marsat (2018), which showed that ESG-related controversies might have an effect on other financial performance measures, but in the short-term, it does not affect any market-oriented or operational metrics.

Conclusion

The study examines the influence of ESG disclosure scores and ESG controversy scores on Return on Assets (ROA), Return on Equity (ROE), Price-to-Equity ratio (PE) and Tobin’s Q of NSE 500 companies from the period of 2020 to 2024. The analysis showcased a significant and positive impact of ESG disclosure scores on Return on Assets and Return on Equity, which implies that when the ESG-related reporting is done in a more transparent manner, the organization's proficiency and financial performance are improved. These findings are corroborated by Freeman's Stakeholder theory (1984), which implies that when an organization engages with its stakeholders through transparent ESG-related disclosure, it sees an improvement in its financial results.

On the other hand, ESG disclosure scores had an insignificant impact on PE and were significant for Tobin’s Q in a negative manner, implying that enhanced levels of transparency in ESG reports might not give instant results in terms of market valuation of the organization, and in some instances, it could be seen as future liabilities, which can be corroborated by studies like McWilliams et al. (2006). Conversely, ESG controversy scores were found to be insignificant towards the financial metrics that were examined, suggesting that ESG-related controversies might now have any impact on the organization's financial performance or valuation in the short term.

Even though the findings from this research provide invaluable insights, there are limitations to this study. We limited the sample of this study to NSE 500 companies, excluding financial institutions, as they have different accounting standards. Due to this, the conclusions are not to be fully generalized to other sectors. Additionally, the research captures a relatively shorter time frame (2020-2024) in order to accommodate the unavailability of ESG-related data of the organizations, so it might not be able to fully grasp the effects of ESG practices and related controversies in the long run. Finally, the use of Prowess IQ, Bloomberg database and Refinitv Eikon might even exclude some relevant ESG-related instances, notably the ones that remain undisclosed to the public.

Research in the future can extend the findings of this study by examining a broader range of sectors, including financial institutions, and by studying the impact of ESG controversies on the financial performance of organizations in the long run. Future research could also employ the use of a wider range of data sources to gain a more expressive understanding of the relationship between ESG scores and the financial performance of organizations.

The implications of the results from this study are significant for corporate managers as well as investors. In the case of managers, the positive relationship shared by ESG disclosure scores and financial results puts emphasis on the relevance of enhanced levels of transparency with regard to ESG reporting. Organizations that are involved in such activities tend to showcase significant improvement in both their shareholders' confidence and their levels of efficiency, which in turn improves their financial performance. In the case of investors, as ESG controversy scores had no significant impact on the financial metrics, they might not get any effect on their market capitalization in the short run, but in the long run, it can still have a negative effect on their financial performance and their corporate standing.

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