

# ESG AND CORPORATE FINANCIAL PERFORMANCE- EVIDENCE FROM NEW ZEALAND

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## ABSTRACT

The research paper reports the impact of New Zealand companies' environmental, social, and governance disclosures on their financial performance and market value. Further, the research examined how financial slack (FS) moderates the relationship between environmental, social, and governance scores (ESGS) and company financial performance. The sample consisted of quarterly data from New Zealand-listed companies from 2010 to 2021. Univariate and multivariate methods were used to test the hypotheses and assess the objectives. The results indicate that the relationship between environmental, social, and disclosures (ESGD) and the market value of companies is positive and significant. However, there exists a negative relationship between ESGD and financial performance. After adding Financial slack(FS) as a moderating variable, the ESGS and financial performance relationship became significant. This suggests when companies have surplus funds, they invest in environmental, social, and governance-related activities which enhances both their financial performance and reputation. The research is helpful to academics, companies, and policymakers interested in understanding the impact of sustainable practices on companies. Furthermore, the findings provide insight into initiatives that regulatory authorities might take to improve environmental, social, and governance disclosures and reporting among New Zealand companies for long-term value creation.

**Keywords:** Environmental, social and governance (ESG), performance, market value, sustainability.

## 1. INTRODUCTION

Over the past few years, environmental, social, and governance (ESG) information has become an important indicator of a company's capability to promote sustainable growth. The United Nations Environment Partnership Financial Initiative (UNEP FI) has been advocating for the incorporation of ESG factors into company decision-making practices since 1992(UNEP FI 1992). As a result, ESGS has become integral for developing sustainable strategies that affect financial performance in companies (Eccles & Serafeim 2013). Furthermore, ESG integration has become a key issue among investors, governments, regulators, companies, and non-governmental organisations (Lee et al., 2016). According to Bassen and Kovacs (2008), ESGS are critical in providing ESG information that investors use in evaluating a company's risks and opportunities. Han et al.,2016b) reported that environmental activity, social responsibility, and governance had a significant effect on a company's ESGS. Additionally, it has been argued that sustainable development encompasses more than just corporate social responsibility (CSR), and non-financial information is critical for company managers to meet their environmental goals (Hank et al., 2013).

New Zealand is one of the countries that are most concerned with issues related to company governance, social equality, and the environment and several initiatives have been launched by the government in New Zealand to develop ESG practices (MBIE, 2021). The New Zealand Stock Exchange (NZX) published a guidance note on ESG reporting in 2017 as part of its updating of the corporate governance code which includes the voluntary disclosure of ESG information by New Zealand companies (NZX Corporate

Governance Code,2020). A Klynveld Peat Marwick Goerdeler (KPMG,2020) report shows that 47% of New Zealand organisations documented sustainability performance in their annual reports. Moreover, 74% of New Zealand companies reported on ESG matters in 2020, up from 69% in 2017 (KPMG, 2020). Additionally, the number of organisations acknowledging climate risks in their financial or annual reports has increased by 13% from 2017 to 2020 (KPMG, 2020). However, there was significant variation in the standard and type of information voluntarily reported as there are varying frameworks and standards for sustainability reporting and a national framework has not yet been established for ESG reporting (KPMG, 2020). This practice causes inconsistency across reports, and it can be difficult, or even impossible, to compare reports of various companies. Nonetheless, the New Zealand government is taking proactive measures to increase the uptake of consistent and comparable sustainability reporting and making it mandatory(MBIE, 2021).

It is not surprising there is a growing body of literature that has examined the impact of ESGs on a company's financial performance (Friede et al., 2015; Lo & Sheu 2007; McWilliams & Siegel 2000; Ortas et al., 2015; Waddock & Graves. 1997). However, there have been different views on the relationship between ESG disclosures (ESGD) and financial performance. Some researchers argue that ESG, which has been regarded as an important part of the strategy of a company, has negative effects on company financial performance (Aboud & Diab, 2018; Aouadi & Marsat, 2018; El Ghoul et al., 2017; Fatemi et al., 2018; Nekhili et al., 2020). On the contrary, other researchers suggest that investing in ESG activities leads to improved financial performance (Cahan et al., 2015; Eccles et al., 2014; Fatemi et al., 2015) and suggest a positive relationship between ESG and financial performance in the long term.

Given these inconclusive results, there is a need to replicate these studies and examine the impact of ESGs on companies' financial performance in New Zealand. Hence the research aims to investigate the impact of ESGs on market valuations and the financial performance of New Zealand companies.

More specifically, the research addresses three research questions.

- (1) What is the impact of ESGs on the financial performance of New Zealand companies?
- (2) What is the impact of the ESGs on the market value of New Zealand companies?
- (3) Does FS moderate the relationship between ESGs and Return on Equity (ROE), Return on Assets (ROA) and Tobin Q.

The research contributes to the literature in three significant ways:

- (1) It provides a broader perspective by examining both resource-based views and stakeholders' theories to understand how ESGs influences company financial performance and market valuation.
- (2) The findings of the research have practical implications for academics, investors, and policymakers to enable them to understand the significance of incorporating ESGs into financial performance reporting.
- (3) It also reflects upon the need to have a proper framework of ESG reporting standards in New Zealand for improved disclosures and accountability by companies.

## **2. LITERATURE REVIEW & HYPOTHESIS DEVELOPMENT**

### **2.1 Relationship between ESG and Company Financial Performance**

Environmental, social and governance disclosures have been studied extensively , however, many studies have found inconclusive results about the relationship between ESGs and financial performance. (Eccles et al., 2014; Orlitzky, 2001).

The traditional neoclassical theory holds that investing in ESG activities increases financial costs for a company (Derwall et al., 2005; Hassel et al., 2005; Palmer et al., 1995; Semenova & Hassel 2008) and ESG practices negatively impact financial performance (Garay & Font, 2017; Revelli & Viviani, 2013). Cassar

&Friedman (2009) suggests that a company's sole purpose is to increase shareholders' wealth and any purpose that deviates from that will reduce the effectiveness of the company. Yoon et al. (2018) documented that ESGD increases companies' costs and decreases the value of the environmentally sensitive company, thus leading to a financial disadvantage. Some other researchers have also reported negative associations between ESGD and financial performance (Branco & Rodrigues 2008; Brammer et al, 2006; Lee et al., 2009). Researchers Lee et al. (2009) noted that ESG investments worsen financial performance and suggest that this might indicate that companies with high ESGs will have lower equity costs. Galani, et al. (2012) report that profitability is not significantly related to ESGD. This is supported by an additional group of authors who conclude that there is no connection between the ESGs and financial performance (Galema et al., 2008; Horvath, 2010; Orlitzky et al., 2003; Statman, 2006)

On the other spectrum, the majority of the extant studies have used the stakeholder theory to explain the positive relationship between ESGs and financial performance ( Brooks & Oikonomou, 2018; Aboud &Diab, 2018; Yoon et al., 2018). They document that the key tool for improving financial performance is managing stakeholder relationships between the company and the stakeholders. As per stakeholder theory (Freeman, 1984), companies are responsible for customers, employees, shareholders, and investors and managers should pay attention to stakeholders' interests, as good relationships with stakeholders can indirectly boost financial results . Furthermore, it is predicted that the integration of environmental and social responsibility into corporate strategies reduces company risk and promotes long-term value creation (Yu & Zhao, 2015). This will lead to a higher level of shareholder value and competitive advantage for companies (Bernardi & Stark, 2018, Li et al., 2018). From the stakeholder and agency perspectives, companies are required to adopt a more long-term, sustainable value view, as stakeholders are concerned about a company's ESG factors, including where it invests and how it conducts business (Atan et al., 2018; Eccles et al., 2014). This is supported by researchers (Aboud Diab & ,2018) who state that a company with socially and environmentally responsible practices combined with good governance practices will satisfy the needs of stakeholders and enhance financial performance. Tantalo & Priem (2016) believe that each essential stakeholder group (including investors, creditors, employees, customers, and regulators) supports ESGD as a potential source of value creation. On the same lines, companies that are involved in ESGD improve their efficiency, strengthen their reputation, and increase their profitability. (Li et al., 2018).

The resource-based theory is suggestive of a positive relationship between ESGD and financial performance and propounds that ESGD may help companies to develop new internal resources as well as generate external benefits through company reputation (Branco & Rodrigues, 2006). According to the resource-based theory, companies that have superior ESG-related disclosures, gain competitive advantages (Branco & Rodrigues, 2006). Another view suggests that companies invest in ESG practices depending on the availability of financial resources (Aguilera-Caracuel et al., 2015; Allouche & Laroche 2005; Waddock & Graves 1997). If companies have resources that can be reallocated, managers will take more innovative actions, satisfying stakeholders' demands (Voss et al., 2008). However, companies are more likely to adopt conservative strategies when financial resources are limited, investing in what they consider to be fundamental for survival (Aguilera-Caracuel et al., 2014).

Summarising the discussions so far, the research proposes the following hypothesis (H):

H1: There is a positive relationship between ESGs and the ROA of New Zealand companies.

H2: There is a positive relationship between ESGs and the ROE of New Zealand companies.

H2: There is a positive relationship between ESGs and Tobin Q of New Zealand companies.

## 2.2 ESG and Financial Slack

Financial resources play a role in determining how a company invests funds in ESG-related related projects (Aguilera-Caracuelet al., 2015; Allouche & Laroche 2005; Surroca et al., 2010; Waddock & Graves 1997).

Companies allocate resources to innovative projects when there are surplus financial resources available to satisfy stakeholders (Voss et al., 2008). In contrast, when financial resources are scarce, companies tend to focus on profitable activities since it is difficult to invest in ESG initiatives because of a lack of financial resources (Sharma, 2000). Apart from reducing costs, ESG initiatives can also improve the visibility and reputation of a company (Aguilera-Caracuel et al., 2017; Miles & Covin 2000). Brammer and Millington (2008) and Velte (2016) conclude that increased transparency of ESG activities by companies have a significant impact on their financial performance.

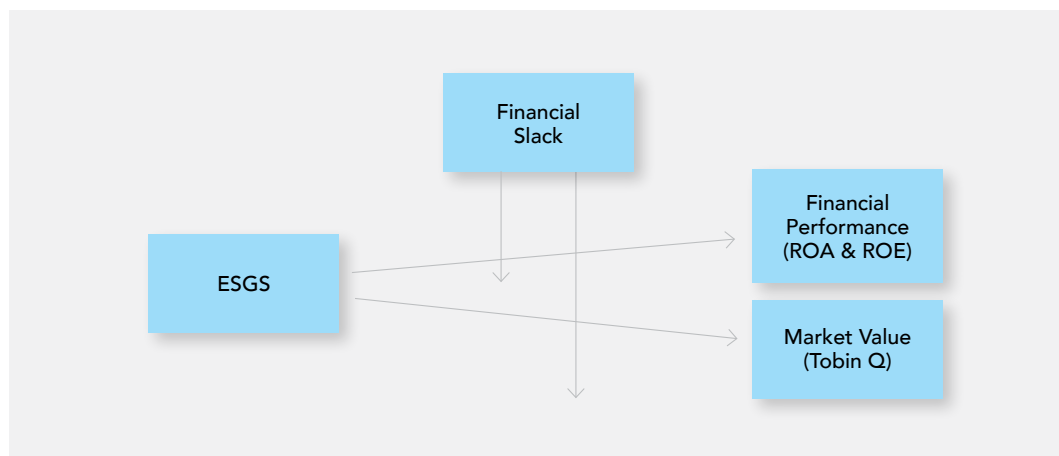
Summarising the discussions thus far, the research investigated how FS moderates the relationship between ESGs and company financial performance and proposes the following three additional hypotheses:

H4: The availability of FS improves the relationship between ESGs and the ROA of companies.

H5: The availability of FS weakens the relationship between ESGs and ROE of companies.

H6: The availability of FS weakens the relationship between ESGs and the Tobin Q of companies.

Figure 1 – Framework Model Showing the Potential Moderating Effect of Financial Slack.



### 3. DATA AND METHODOLOGY

#### 3.1 Data

The sample for the research consists of New Zealand publicly listed companies with complete data available from DataStream. Quarterly data has been collected for the research ranging from the first quarter of 2010 to the first quarter of 2021, consisting of 11 years or 46 quarters. All continuous variables are winsorized at 5% and 95% levels to eliminate the effect of outliers. Companies engaged in the business of tobacco, alcohol, controversial weapons, and gambling operations have been excluded from the research.

#### 3.2 Methodology

The research investigated the effect of ESGs on companies' financial performance and market value by using the fixed effects model as this considers the variation in time and cross-sections. To overcome the problem of omitted variables and endogeneity, the model includes control variables. Furthermore, to determine multicollinearity among independent variables, Variance Inflation Factor (VIF) is estimated. A VIF value of 1 means there is no correlation between independent variables in the model and a VIF value of 1-5

indicates a moderate relationship between a given explanatory variable and its explanatory variables, but it is not severe enough to require attention. While a VIF greater than 5 indicates that there is a high correlation between variables and regression analysis cannot be carried out.

For determining the effect of ESGS on financial performance and market value, three regressions were performed with ROA, ROE, and Tobin Q as the dependent variables. The first set of panel data regression analysis was completed to examine the relationship between ESGS and dependent variables namely the market value (Tobin Q) and financial performance (ROA and ROE).

$$ROA_{it} = b_0 + b_1ESGS_{it} + b_2size_{it} + b_3 leverage_{it} + e \quad (1)$$

$$ROE_{it} = b_0 + b_1ESGS_{it} + b_2size_{it} + b_3 leverage_{it} + e \quad (2)$$

$$TobinQ_{it} = b_0 + b_1 ESGS_{it} + b_2 size_{it} + b_3 leverage_{it} + e \quad (3)$$

where 'it' represents the company 'i' in year 't'; 'b0' is the constant term, and 'e' is the error term.

The next set of regression was used to determine the change in the relationship between ESGS and the company's financial performance due to moderating variable and to test the hypothesis that the impact of ESGS disclosure on company financial performance will be enhanced in companies with FS as a moderating variable. The analysis was performed using the same baseline regression model with FS as a moderating variable.

### 3.3 Measurement of Variables

The research evaluated the companies' performance along three dimensions: financial, operational, and market performance measured by ROE, ROA, and Tobin Q. Financial leverage and company size were control variables in the research.

The dependent variables were based on previous studies, with the ROA variable chosen as a measure of profitability, as it is one of the broadest measures of a companies' operating performance (Russo et al., 1997) Additionally, it is used to measure the efficiency of a company enterprise in utilising its property to generate revenue. The second dependent variable is ROE which indicates how successful companies manage their capital (net worth) and how profitable their investments are as shareholders of the company. The third variable Tobin Q, was used to assess the market value of the companies (Aboud Diab ,2018; El Ghouli et al., 2017 & Li et al., 2018). This variable has been extensively used to measure the market value of companies, e.g., Albertini (2013), Garg (2015), Yu and Zhao (2015). It is both a measure of past financial performance and a representation of future development expectations (Li et al., 2019). Tobin Q is calculated as the sum of market capitalisation and the book value of total assets minus net worth divided by the book value of total assets.

An ESGS was the independent variable, and it ranges from 0 to 100 based on the amount of ESG data disclosed by companies. Recently, ESGS provided by Bloomberg have been widely used in the academic literature (Manita et al., 2018 ;Nollet et al., 2016).

Financial slack was used as a moderating variable. It was measured by the amount of liquid assets that are available for investing in various activities by a company (Kraatz & Zajac 2001). Financial slack is calculated by dividing current assets by current liabilities.

Company size and financial leverage were used as control variables. Studies have indicated that company size and financial leverage are key control variables when testing the impact of ESGS on financial performance (Andersen & Dejoy, 2011; Margolis et al., 2009). According to Sen (2011), a company's size is significantly related to its ESGS. Several studies have demonstrated that large companies may be more efficient since they can utilise economies of scale, employ more skilled managers, and formalise procedures to produce better results (Naik, 2014). Company size is measured as the log of its total assets. Leverage

refers to a company's use of borrowed funds. It is measured by the ratio of total liabilities to the net worth of the company. In the research, leverage is included since financial institutions traditionally pay more attention to ESG information as leverage increases (Ghosh, 2013).

#### 4. EMPIRICAL RESULTS

##### 4.1 Univariate Analysis

Table 1 – Table showing summary statistics for all variables

| VARIABLE     | N     | MEAN | MEDIAN | MIN   | MAX  |
|--------------|-------|------|--------|-------|------|
| ROA          | 2,507 | 4.5  | 10.6   | -29.3 | 57.7 |
| ROE          | 2,524 | 8.1  | 14.2   | -32.5 | 37.5 |
| Tobin Q      | 2,555 | 1.5  | 1.9    | 0.2   | 8.6  |
| ESGS         | 2,499 | 24.6 | 16.2   | 0.0   | 70.6 |
| Company Size | 2,761 | 13.4 | 1.5    | 10.3  | 15.8 |
| Leverage     | 2,015 | 2.4  | 3.9    | 0.1   | 19.8 |
| FS           | 2,507 | 4.5  | 10.6   | -29.3 | 57.7 |

Notes: This table shows summary statistics for all variables. Summary statistics include number of observations(N), mean, standard deviation, median, minimum(Min), and maximum(Max) values of all variables.

Table 1 reveals summary statistics for selected dependent, independent, and control variables. The descriptive statistics includes minimum, maximum, mean, and standard deviation for the dependent, independent, and control variables. The sample, ROA has a mean of 4.5 (median = 10.6), ROE has a mean of 8.1 (median = 14.2) and Tobin Q has a mean of 1.5 (median = 0.2). Based on the mean values in the sample, it can be concluded that the companies in the sample are profitable. Companies have a mean ESGS of 24.6 (median = 16.2).

On average companies' current ratio is 4.5, which is a measure of short-term stability. On average, leverage of the companies in the sample is 2.4 and the mean company size is 13.5 (median = 10.6).

Table 2 – Correlation Matrix for all variables

|              | ROA   | ROE   | TOBIN Q | ESGS  | FS    | LEVERAGE | COMPANY SIZE |
|--------------|-------|-------|---------|-------|-------|----------|--------------|
| ROA          | 1     |       |         |       |       |          |              |
| ROE          | 0.92  | 1.00  |         |       |       |          |              |
| Tobin Q      | -0.12 | -0.13 | 1.00    |       |       |          |              |
| ESGS         | 0.17  | 0.16  | -0.02   | 1.00  |       |          |              |
| FS           | -0.14 | -0.22 | 0.29    | -0.08 | 1.00  |          |              |
| Leverage     | -0.07 | -0.02 | -0.25   | 0.09  | -0.11 | 1.00     |              |
| Company size | 0.19  | 0.20  | -0.44   | 0.33  | -0.22 | 0.33     | 1            |

According to the correlation matrix, ROA and ROE are positively correlated with ESGS, but there exists a negative correlation between Tobin Q and ESGS. The coefficients for the independent variables are all below .80, which means that there is no significant correlation between them.

According to the test result of VIF, the value between independent variables is 1.8. Therefore, the results are not biased by the problem of multicollinearity.

#### 4.2 Multivariate analysis

**Table 3 – Fixed Effects Panel Data Regression**

| VARIABLES    | ROA                  | ROE                  | TOBIN Q              |
|--------------|----------------------|----------------------|----------------------|
| ESGS         | -0.076***<br>(0.000) | -0.124***<br>(0.000) | 0.029***<br>(0.000)  |
| Leverage     | -0.161<br>(0.000)    | -0.171***<br>(0.000) | 0.002<br>(0.344)     |
| Company Size | 5.530***<br>(0.000)  | 6.729***<br>(0.000)  | -1.090***<br>(0.000) |
| Constant     | -65.28***<br>(0.000) | -76.35***<br>(0.000) | 15.61***<br>(0.000)  |
| R squared    | 0.1227               | 0.1425               | 0.344                |
| Observations | 1,569                | 1,572                | 1,573                |

Note: Table 3 presents the estimation results of the fixed effect panel regressions for three different outcome variables; ROA, ROE, and Tobin Q. All variables were winsorized at 5%. p-values are reported in parentheses. \*, \*\*, and \*\*\* denote significance at the 10%, 5%, and 1% levels, respectively.

Based on the first set of fixed term panel regressions, the ESGS negatively affects financial performance. Results indicate a negative significant relationship between ESGS with ROA and ROE, which is in line with the studies completed by Brammer et.al. (2006). Furthermore, the results suggest that ESG activities lead to additional costs for companies and lowers their financial performance. Hence, hypotheses 1 and 2 are rejected.

Additionally, results indicate a positive and significant relationship between ESGS and Tobin Q. Hypothesis 3 is accepted which suggests that the ESGS increases the value of the company. The findings of the study are consistent with stakeholder theory (Aboud & Diab , 2018; Brooks & Oikonomou,2018 & Yoon et al.2018), which suggests that ESG activities satisfy the needs of stakeholders and enhance financial performance. In addition, the results support the resource-based theory (Branco & Rodrigues, 2006), which states that ESG activities lead to internal resource development and increased corporate reputation.

**Table 4 – Fixed Effects Panel Data Regression with Moderating Variable**

| VARIABLES    | ROA                  | ROE                  | TOBIN Q              |
|--------------|----------------------|----------------------|----------------------|
| FS           | 0.034***<br>(0.000)  | 0.042***<br>(0.000)  | 0.000<br>(0.979)     |
| Leverage     | -0.179***<br>(0.000) | -0.187***<br>(0.000) | 0.003<br>(0.309)     |
| Company Size | 5.843***<br>(0.000)  | 7.318***<br>(-0.662) | -1.145***<br>(0.000) |
| Constant     | -67.15***<br>(0.000) | -80.46***<br>(0.000) | 16.15***<br>(0.000)  |
| R squared    | 0.103                | 0.095                | 0.347                |
| Observations | 1,212                | 1,246                | 1,240                |

Note: Table 4 presents the results of the fixed effects panel regressions for three different outcome variables: ROA, ROE, and Tobin Q with FS as a moderating variable. All variables were winsorized at 5%. p-values are reported in parentheses. \*, \*\*, and \*\*\* denote significance at the 10%, 5%, and 1% levels, respectively.

Table 4 shows the results of the fixed effects panel regression analysis with FS as a moderating variable. The empirical results suggest that FS has a significant impact on the relationship between ESGS scores and the financial performance of New Zealand companies. It is interesting to note that, with the appearance of moderating variables, the observed linkages between companies’ ESGS and financial performance have increased significantly. It was found that with the existence of FS there is a significant positive relationship between ESGS and financial performance measures, ROA, and ROE. This indicates that when companies have surplus funds, they invest in ESG-related activities which enhances companies’ performance when FS is taken as a moderating variable. The results show that managers view environmental activities as a long-term option and only invest in sustainability activities when they have extra funds (Aguilera-Caracuelet al., 2015; Allouche & Laroche 2005; Surroca et al., 2010; Waddock & Graves 1997).

**5. ANALYSIS & DISCUSSION**

The research illustrates the impact of the ESGS on financial performance and market value for companies in New Zealand. Financial indicators and ESGD demonstrate the validity of stakeholders’ theory and indicate that shareholders are concerned about the company’s ESG activities. This is in line with studies completed by Bernardi and Stark (2018), Yu and Zhao 2(015), and Li et al.(2018)who suggest that companies with socially and environmentally responsible practices combined with good governance practices satisfy the needs of stakeholders and enhance market value. However, the negative relationship between ESGS and ROA, and ROI indicate that ESG-related activities add additional expenses for companies (Branco & Rodrigues 2008; Brammer et al., 2006; Lee et al., 2000) and lead to financial disadvantage.

Second, with FS as the moderating variable, the linkages between companies and financial performance alter. An interesting conclusion can be drawn from the findings that when managers no longer need to worry about repayment times, and short-term expenses and have sufficient financial reserves, they are more likely to support ESG investments or initiatives to meet the needs of their various stakeholders. This is in line with studies conducted by Aguilera-Caracuelet al. (2015), Allouche & Laroche (2005), Sharma (2000), Surroca et al. (2010), and Waddock and Graves (1997).A positive relationship between financial performance and environmental concerns suggests that companies view environmental investments as a long-term strategy to increase their reputation and attract investors (Bassen & Kovacs 2008; Tantalo & Priem, 2016) rather than a short-term strategy. Furthermore, the results show that companies tend to



incorporate ESG activities into their strategy because it provides a competitive advantage.

Third, the empirical results provide a rationale for policymakers to enact the ESG framework for companies to update their ESGD and notify all stakeholders of the financial and social outcomes of their activities. In addition, the research offers insight to the government to create long-term incentives for companies adopting ESG-related practices in their strategies and objectives.

## 6. SCOPE AND LIMITATIONS

The research examines how the total ESGs affects the financial performance of companies, but it can also be replicated using individual ESG parameters to gain a wider perspective. The sample size was small as the research relied on data being provided by companies that disclosed their ESGs. There is potential for future studies to be conducted using a wider range of countries and a larger sample size.

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