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Impact of ESG Ratings on Corporate Financial Performance: A Panel Study of Indian Listed Enterprises

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Abstract:

The significance of sustainable and responsible investment strategies has steadily risen due to the increased cognizance of environmental, social & governance (ESG) aspects in the emerging economies like India. Hence, by taking ESG into investment consideration, the study has made a sincere attempt to empirically investigate the impact of ESG rating on the profitability and value of Indian publicly listed entities, which can be measured by various indicators such as return on assets (ROA), Tobin's Q ratio etc. The study has used annual ESG ratings published by CRISIL, pertaining to 54 Indian companies listed on BSE 100 ESG Index, covering the period from year 2022 to 2024. The random effects panel data regression analysis has been employed to test the significance of ESG factors on the firm performance. The findings of the study indicate that higher ESG rating enhances the financial performance of the firm, as evaluated by both accounting and market related measures. The findings have practical implications on corporations, investors, policy-makers as well as regulatory bodies. Further, the study highlights the need for robust sustainability reporting among Indian listed enterprises.

Key-words: ESG, Corporate sustainability, Sustainability performance, Firm performance, Panel data regression.

Introduction:

Over the past ten years, India has experienced notable shifts in its regulatory landscape. A key development came in 2013 when the Companies Act was amended, introducing Section 135, which mandates that qualifying companies allocate 2% of their average annual net profits towards Corporate Social Responsibility (CSR) initiatives.

From an investment perspective, there has been a growing interest in sustainable and responsible investing. One prominent strategy within this realm is the adoption of Environmental, Social, and Governance (ESG) criteria for portfolio selection. This approach has gained traction, largely influenced by organizations such as the United Nations Environment Program Finance Initiative.

ESG investing is founded on the belief that companies committed to social responsibility, environmental care, and strong governance tend to hold intangible advantages. These companies are perceived to have better capabilities in managing risks related to ESG factors, leading to long-term value creation and sustainable business practices.

The ESG framework evaluates an organization's non-financial performance across various dimensions, they are as follows:

- Environmental: Issues such as pollution, waste management, climate change, water scarcity, waste management, and deforestation.
- Social: Issues such as labour rights, rights of local and indigenous populations, conflict zones, health and safety standards, employee relations, diversity & inclusivity.
- Governance: Issues including executive compensation, corruption and bribery, political lobbying and donations, board composition, and corporate tax strategies.

Traditionally, business success was primarily measured through financial metrics such as profitability, return on investment (ROI), and shareholder value (Friedman, 2007). However, in response to global challenges like climate change, social inequality, and government failures, the business community has begun to adopt a broader approach that incorporates Environmental, Social, and Governance (ESG) issues into its decision-making processes (Elkington, 1999; Eccles et al., 2014).

The shift toward sustainability-based business models gained momentum with the Triple Bottom Line (TBL) approach by Elkington (1999), which expanded corporate performance measurement beyond financial metrics to include environmental and social aspects. Under this framework, a business's success is assessed based on three main pillars: economic performance, which provides for traditional financial indicators such as profitability, top-line growth, and return on assets; social performance, which encompasses corporate social responsibility (CSR), staff well-being, diversity, and community engagement; and environmental performance, which accounts for factors like carbon footprint, energy efficiency, waste management, and material conservation.

The growth of ESG investing aligns with sustainable and responsible investment principles, leading to a significant transformation in capital markets (Friede et al., 2015). Investors increasingly prioritize firms with strong ESG performance because they believe these companies are better equipped to manage risks, enhance reputation, and achieve long-term financial success (Broadstock et al., 2020). Empirical research has shown a positive correlation between ESG performance and financial performance, indicating that firms with robust sustainability strategies outperform their peers over time (Clark et al., 2015). Several key mechanisms underlie this connection: risk mitigation, where effective governance and environmental practices minimize regulatory risks and reputational damage (Eccles et al., 2014); operational efficiency, as companies with sustainability initiatives, such as energy efficiency programs, often realize cost savings and productivity improvements (Alareeni & Hamdan, 2020); and investor confidence and market value, with firms boasting high ESG scores more likely to attract institutional investment, resulting in higher stock prices and reduced capital costs (Friede et al., 2015).

A GSIA (2020) report indicated that ESG-oriented assets under management (AUM) exceeded $35 trillion globally, accounting for nearly 36% of all global investments. ESG-integrated funds demonstrated notable resilience during periods of financial instability, consistently outperforming traditional portfolios, particularly amid the challenges posed by the COVID-19 pandemic (Broadstock et al., 2020). India has placed a greater emphasis on ESG practices due to regulatory demands, increased investor awareness, and corporate social responsibility initiatives (Tyagi, 2021), with the government and regulators issuing various ESG-related guidelines to promote sustainable business practices. Notable developments include the National Voluntary Guidelines (NVGs) (2011), launched by the Ministry of Corporate Affairs (MCA) to provide an organized framework for Indian companies to adopt responsible practices (MCA, 2011), and the Business Responsibility and Sustainability Reporting (BRSR) (2021), which mandates ESG reporting for the top 1,000 listed companies starting from FY 2022–23 to enhance transparency and accountability (SEBI, 2021). Additionally, heightened investor interest is reflected in a report by the Economic Times (2021), which noted a 34% growth in AUM of Indian ESG-oriented funds during 2021.

Despite recent advancements, research on the financial impact of ESG remains limited in India, especially regarding its effects on corporate profitability, risk management, and investor confidence (Tripathi & Bhandari, 2015). With India's economy advancing rapidly, the regulatory landscape is changing, and environmental and social issues are increasingly prominent. It is essential to analyse the financial implications of ESG performance. This study seeks to explore the relationship between ESG scores and financial performance through an evaluation of 50 firms listed on the Bombay Stock Exchange (BSE). The research aims to address key questions concerning the connection between ESG performance and financial results in Indian companies. It endeavours to determine whether strong ESG practices positively influence a company's profitability, identify which of the ESG dimensions—Environmental, Social, or Governance—has the most substantial impact on financial success, and examine how ESG disclosure affects investor confidence and stock market outcomes.

This research adds to the expanding literature on ESG by answering critical questions and offering valuable insights for policymakers, investors, and business leaders. It equips Indian businesses to align their strategies with global sustainability trends, ensuring long-term competitiveness in the international market.

Literature Review:

The term Environmental, Social, and Governance (ESG) factors has changed over the years, with various terms from the past linked to the field, including socially responsible investment (Sparkes & Cowton, 2004; Friedman & Miles, 2001), sustainability practices (Alshehhi et al., 2018; Ameer & Othman, 2012), ethical investment (Sparkes, 2001; Michelson et al., 2004), and impact investing (Hebb, 2013). Fulton et al. (2012) propose that corporate social responsibility (CSR) and corporate governance (CG) has evolved into Environmental Social Governance (ESG) with the increased significance of both governance structures and social responsibility of businesses to become responsible corporate citizen for its stakeholders.

Multiple studies have considered the correlation between ESG metrics and financial performance. Velte (2017) reported a positive association of ESG with Return on Assets (ROA) but not with Tobin's Q, with governance showing the strongest association among ESG metrics. Conversely, Fauzi et al. (2007) and Siew et al. (2013) reported no significant association between ESG performance and financial performance across various industries. Carpenter et al. (2009) surveyed 16 ESG and firm performance studies, finding ten positive, two negative, and four neutral correlations, emphasizing methodological and contextual variations.

In the Indian context, Chelawat and Trivedi (2016) identified a positive correlation between ESG and financial performance. Ghosh (2013) utilized Ohlson's model to illustrate that firms with attributes such as size, affiliation with business groups, low leverage, and higher R&D spending demonstrated improved sustainability and financial performance. Balasubramanian et al. (2010) established that governance reforms enhanced firm value and performance, respectively. Singh (2010) demonstrated a positive correlation between environmental management and profitability, while Tyagi (2012) found an inconclusive correlation between Corporate Social performance (CSP) and corporate financial performance (CFP).

The theoretical framework of ESG disclosures is rooted in legitimacy theory, agency theory, and signalling theory. According to legitimacy theory, firms disclose ESG practices to receive societal approbation (Dowling & Pfeffer, 1975). Agency theory explains that ESG disclosures help eliminate information asymmetry between shareholders and management (Meckling & Jensen, 1976). Signalling theory posits that ESG disclosures increase a firm's credibility and long-term value (Spence, 1973; Velte & Stawinoga, 2020).

Recent research indicates a growing body of literature confirming a positive correlation between ESG and financial performance. Friede, Busch, and Bassen (2015), Chelawat and Trivedi (2016), Bodhanwala and Bodhanwala (2018), and Dalal and Thaker (2019) found that ESG disclosure adds value to firms. However, some studies report mixed findings with no or weak significant correlation (Velte, 2017; Buallay, 2019; Jyoti & Khanna, 2021). Key financial indicators impacted by ESG include ROA, ROE (Bodhanwala & Bodhanwala, 2018; Buallay, 2019), Earnings Per Share (EPS) (Ahmad et al., 2021), market-to-book ratio (Qureshi et al., 2021), and Tobin's Q (Chelawat & Trivedi, 2016; Dalal & Thaker, 2019). Although, large-scale worldwide research identifies the role of ESG in firm performance, studies within the Indian context remain scarce.

Research Design and Methods:

Data and Sample:

This study utilizes annual ESG ratings published by CRISIL, focusing on 54 Indian companies listed on the BSE 100 ESG Index. The sample period spans three years, from 2022 to 2024. These companies represent a cross-section of Indian industries adhering to environmental, social, and governance (ESG) disclosure norms and sustainability practices. The firms are selected based on ESG ratings, excluding those involved in controversial sectors such as tobacco, alcohol, gambling, and arms manufacturing, as well as those with ongoing major ESG controversies.

Measurement of Variables:

- **Independent Variable**: The ESG score is the key independent variable. ESG performance ratings provided by CRISIL incorporate a score-based methodology that evaluates companies across three dimensions—Preparedness, Disclosure, and Performance—under each of the ESG pillars. Scores range from 0 to 100 and are sector-adjusted for relevance.

- **Dependent Variables**:
    - **Return on Assets (ROA)**: Measures accounting-based profitability, calculated as net income divided by average total assets.
    - **Tobin's Q**: Captures market-based firm value. Calculated as (Market Capitalization + Book Value of Total Assets – Net Worth) / Book Value of Total Assets.
- **Control Variables**:
    - **Leverage**: Total Assets divided by Net Worth, captures unsystematic firm risk.
    - **Size**: Natural logarithm of total assets.

Hypothesis Development:

ESG Factors and Firm Value:

Numerous studies have examined how environmental, social, and governance (ESG) performance influences a company's value, but the findings have been inconsistent. This inconsistency stems mainly from two issues: limitations in measurement or data availability, and flaws in model design. Fatemi et al. (2017) found that ESG initiatives and their transparency can enhance a company's value, while weaknesses in these areas can have the opposite effect. Li et al. (2018), using data from FTSE 350 firms, also identified a positive link between ESG disclosure and firm value, suggesting that transparency and accountability build stakeholder trust and boost value. Similarly, Gutsche et al. (2017) reported a positive association between corporate social responsibility (CSR) disclosures and company value.

Despite these findings, some researchers have observed either a negative or weak positive connection between ESG metrics and stock performance (e.g., Richardson and Welker, 2001; Brammer et al., 2008; Sila and Cek, 2017). The academic debate also extends to which financial performance indicators are most appropriate. Many scholars favour market-based metrics—like Tobin's Q, price-to-earnings ratio, enterprise value, and cash flows—as they better reflect future-oriented performance influenced by sustainability. However, such market-based indicators may encompass more than just financial performance, while accounting-based measures reflect past performance. Consequently, this study uses a combination of both types of measures to evaluate firm performance, with Tobin's Q serving as the market indicator. Based on previous research, this study hypothesizes:

H1: ESG factors have a significant positive impact on the value of publicly traded Indian companies.

ESG Factors and Profitability:

A company's financial performance can be assessed using either accounting-based or market-based metrics, or a combination of both. When focusing on accounting-based metrics, profitability ratios are key indicators. These ratios evaluate a firm's capacity to generate profits relative to its expenses over a set period. According to Ghosh (2013), better sustainability performance correlates with improved financial outcomes across various accounting and market metrics. Common profitability ratios include Return on Assets (ROA), Return on Equity, Return on Investment, and Return on Capital Employed. This study employs ROA to measure a company's operational performance. Previous research has also used ROA for similar analyses (e.g., Albertini, 2013; Lech, 2013; Garg, 2015; Hou et al., 2016). Therefore, based on the review of literature, the following hypothesis is proposed:

H2: ESG factors have a significant positive relationship with the profitability of publicly traded Indian companies.

Results and Discussion:

The study has employed **Random Effects Panel Data Regression Analysis**, justified through the Hausman test, which confirmed the suitability of the random effects model over fixed effects for both dependent variables. The regression models are as follows:

Model 1 $ROA_{it}=\beta_0+\beta_1 ESGit+\beta_2 Size_{it}+\beta_3 Leverage_{it}+\varepsilon_{it}$

Model 2 Tobin's $Q_{it}=\beta_0+\beta_1 ESG_{it}+\beta_2 Size_{it}+\beta_3 Leverage_{it}+\varepsilon_{it}$

Table 1.1 Descriptive Statistics

Variable	Mean	Median	Std. Dev	Min	Max
ROA	8.72	6.10	10.85	-8.50	70.30
Tobin's Q	2.64	1.61	2.38	0.65	12.98
ESG Score	61.02	60.00	10.23	40.00	94.00
Leverage	5.38	3.32	4.87	1.00	23.50
Size (log TA)	13.34	13.42	1.49	10.45	17.05

The above descriptive statistics provide an overview of the variables used in the study for the period 2022–2024 across the 54 firms analyzed. The mean ESG score is approximately 61.02, with a median of 60.00 and a standard deviation of 10.23, indicating a moderate level of ESG performance across the sample with some variation. The average Return on Assets (ROA), used as the accounting measure of profitability, stands at 8.72, while Tobin's Q, reflecting the market valuation of firms, has a mean of 2.64. Both ROA and Tobin's Q exhibit substantial dispersion, suggesting heterogeneity in financial performance among the firms. Control variables also display expected variation: leverage (mean = 5.38) and firm size (log of total assets, mean = 13.34). Overall, these descriptive statistics suggest a diverse sample of firms in terms of financial and ESG performance characteristics.

Table 1.2 Correlation Matrix

	ROA	Tobin's Q	ESG	Leverage	Size
ROA	1				
Tobin's Q	0.577**	1			
ESG	0.172*	0.089	1		
Leverage	-0.301**	-0.347**	-0.201*	1	
Size	-0.398**	-0.611**	-0.017	0.624**	1

*Note: *p < 0.05, **p < 0.01*

The Pearson correlation matrix reveals the bivariate relationships among the study variables. ESG ratings are **positively and significantly correlated with ROA** (correlation coefficient = 0.172, $p < 0.05$), suggesting that firms with better ESG performance tend to report higher profitability. However, the correlation between ESG and Tobin's Q is weaker and not statistically significant (correlation coefficient = 0.089), indicating that the market valuation response to ESG may be more nuanced. ROA and Tobin's Q are significantly and positively correlated (0.577, $p < 0.01$), as expected, since both measure different aspects of firm performance. Notably, leverage is negatively correlated with both ROA and Tobin's Q, indicating that highly leveraged

firms may face constraints on profitability and market valuation. Size also shows a significant negative correlation with both performance metrics, which may imply that larger firms experience lower efficiency or greater scrutiny. No multicollinearity is evident based on the magnitude of correlations.

Table 1.3 Variance Inflation Factor

Variance Inflation Factor			
Test Summary	**Independent Variables**		
	ESG	Size	Leverage
Variance Inflation Factor	1.076	1.608	1.793
Note: Minimum possible value = 1.0; values >10.0 may indicate a collinearity problem.			

Table 1.4 Hausman Test results:

Dependent Variable	**Chi-Square**	**p-Value**
ROA	1.2124	0.7769
Tobin's Q	0.1923	0.9832

A multiple regression model's predictor variables' influence of collinearity is gauged by the Variance Inflation Factor (VIF). One is the minimal VIF value, whereas multicollinearity problem in the regression model is indicated by a number greater than 10. The VIF test results for the predictor variables are displayed in Table 1.3. Every predictor variable's VIF value falls within acceptable limits, hence there is no problem of multi-collinearity in the model.

Further, the Hausman test was conducted to determine the appropriateness of using a fixed effects model versus a random effects model for the panel data regression. For both dependent variables—ROA and Tobin's Q—the p-values were greater than 0.05 (0.7769 and 0.9832 respectively), indicating that the null hypothesis (that random effects is consistent and efficient) cannot be rejected. Therefore, the random effects model is deemed appropriate for both regression models in this study. This choice allows for more generalizable inferences, assuming that individual firm effects are uncorrelated with the explanatory variables. Hence, random effects model is preferred for both ROA and Tobin's Q models.

Regression Results:

Table 1.5: ROA (Random Effects Generalized Least Squares)

Variable	Coefficient	Std. Error	z	p-Value
Constant	42.893	8.102	5.294	1.16e-07***
ESG	0.071	0.037	1.921	0.0541*
Leverage	0.018	0.191	0.094	0.9251
Size	-2.894	0.652	-4.437	9.12e-06***

The above regression results indicate a **positive and marginally significant relationship** between ESG ratings and Return on Assets (ROA) at the 5% significance level. The coefficient for ESG is 0.071 with a p-value of 0.0541, suggesting that an improvement in ESG performance is associated with an increase in the firm's accounting profitability. This supports the hypothesis that sustainable business practices contribute positively to operational efficiency. The firm size, represented by the natural logarithm of total assets, shows a **negative and statistically significant impact** on ROA with a coefficient of -2.894 and a p-value well below 0.01. This implies that larger firms, possibly due to complexity, bureaucracy, or increased stakeholder pressure, tend to exhibit lower ROA. Leverage, measured as the ratio of total assets to net worth, has an insignificant effect on ROA ($p = 0.9251$), indicating that capital structure does not materially influence accounting-based profitability in this context.

Table 1.6: Tobin's Q (Random Effects Generalized Least Squares)

Variable	Coefficient	Std. Error	z	p-Value
Constant	15.983	1.904	8.393	4.18e-017***
ESG	0.021	0.006	1.802	0.0714*
Leverage	0.029	0.031	0.935	0.3492
Size	-1.065	0.148	-7.198	3.01e-013***

The above table reports the results of the regression with Tobin's Q as the dependent variable, which captures market-based valuation of the firm. The ESG coefficient is positive (0.021) and marginally significant ($p = 0.0714$), suggesting that **higher ESG ratings contribute to enhanced firm valuation**, although the effect is less robust than that observed for ROA. This result aligns with the notion that capital markets are increasingly recognizing and rewarding firms with strong ESG profiles. Similar to the ROA model, firm size shows a **significant negative relationship** with Tobin's Q (coefficient = -1.065, $p < 0.01$), reinforcing the idea that market participants may perceive larger firms as less agile or more exposed to sustainability-related risks. Leverage remains statistically insignificant ($p = 0.3492$), indicating that the capital structure does not have a discernible impact on the market valuation of the firms in the sample.

Conclusion and Future Scope:

This research makes a valuable contribution to the Indian literature on ESG impact assessment. It clearly demonstrates that companies with higher ESG ratings tend to achieve stronger financial outcomes. Unlike previous studies, this paper applies a more rigorous methodology by evaluating financial performance using both accounting-based indicators—typically linked to short-term results—and market-based indicators, which better reflect long-term performance. The use of multiple financial metrics enhances the depth and reliability of the analysis, making it a notable addition to current research.

The study's findings are especially relevant for investors, regulatory bodies, policymakers, and Indian corporations. The evidence suggests that investors are drawn to companies that exhibit better environmental practices, greater social acceptance, and transparent governance. Businesses with lower ESG-related risks are more likely to maintain sustainable financial performance, making them more attractive to long-term investors. To meet these expectations, companies must adopt sustainable operational strategies and strong governance frameworks. Moreover, the research emphasizes the importance of implementing sustainability reporting, including the disclosure of ESG scores. Regulators are encouraged to expand mandatory disclosure requirements to encompass not just financial data, but also the social and environmental effects of corporate activities. This broader focus would support the advancement of sustainable business strategies and help ensure the long-term growth of shareholder value.

Despite its contributions, the study has some limitations. ESG reporting and indexing are still developing, with inconsistent standards across different platforms. The study's three-year timeframe may be insufficient to fully capture ESG's influence on financial performance, indicating a need for longer-term analyses. Additionally, ESG ratings might not accurately represent a company’s actual ESG efforts. Other factors, such as the competitive landscape or business environment, might also influence financial results. These areas warrant further exploration. Future research could also benefit from examining the individual effects of the separate ESG components on financial performance.

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