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ESG and Corporate Financial Performance: How Environmental, Social, and Governance Factors Influence Stock Prices - A Comprehensive Literature Review

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ABSTRACT

ESG, which stands for Environmental, Social, and Governance, is critical in measuring company investments' sustainability and ethical impact. By focusing on ESG factors, companies aim to achieve financial profits while contributing to social and environmental welfare, ultimately enhancing their overall performance and competitiveness in the market. Companies with strong ESG performance often show improved financial results, including increased stock value. This study aims to collect and analyse articles on how a company's ESG practices attract investors and influence market perception of its stock value. The research methodology involves a literature review, with articles from platforms such as ScienceDirect, Publish or Perish, and Google Scholar focusing on those published between 2016 and 2024. The findings indicate that ESG practices significantly influence stock prices, with stocks having high ESG ratings, also known as "green stocks," offering higher returns for investors.

INTRODUCTION

The European Union's Sustainable Finance Disclosure Regulation (SFDR) has been in effect since March 2021. The regulation requires financial institutions to disclose financial information covering environmental (E), social (S), and governance (G) factors.(Chung et al., 2023)The relationship between ESG performance and a Company's market value is expected to strengthen in the capital markets as ESG development continues.(Hassel, 2013)Companies, investors, and stakeholders have understood the importance of ESG issues worldwide, which has led some investors to integrate ESG factors into their analyses.(Heijningen, 2019).

One of the main issues related to ESG (Environmental, Social, and Governance) is the lack of uniform global standards for ESG reporting and assessment. Without clear standards, it is difficult for investors to compare ESG performance across companies accurately. Chatterji, Durand, Levine, and Touboul (2016) stated that this inconsistency in ESG assessments leads to significant variations in assessment results and interpretations that confuse investors and make investment decisions more complex. This impacts stock prices because investors may doubt the validity of ESG claims made by companies, which can affect their decisions to buy or sell shares. Kim and Lyon (2015) stated that the impact of ESG on financial performance can be insignificant in some cases, depending on how ESG is measured and the specific indicators used. The lack of agreement on measuring ESG performance adds complexity to determining how ESG affects stock prices. This means that while ESG can play a role in determining a company's value, that impact is not always directly measurable or in the short term.

The increasing awareness of the importance of ESG is in line with increasing pressure from various stakeholders, including investors, consumers, and governments, demanding that companies act more socially and environmentally responsible. According to Eccles and Serafeim (2013), companies that pay attention to ESG tend to have better reputations, stronger relationships with stakeholders, and better access to capital. Another study by Khan, Serafeim, and Yoon (2016) showed that companies with good ESG performance attract more investment and have better financial performance in the long term. This shows that sustainability has become a critical factor that companies that want to remain competitive in a global market that is increasingly aware of social and environmental issues must consider.

Stock markets often react quickly to ESG-related information, both positive and negative. Research by Krüger (2015) shows that negative news related to ESG violations tends to trigger a stronger market reaction than positive news, indicating an asymmetry in how the market processes ESG information. When negative news occurs, investors tend to sell their stocks faster, leading to a decline in stock prices. This suggests that ESG information can cause high volatility in the stock market, which can be challenging for investors seeking stability.

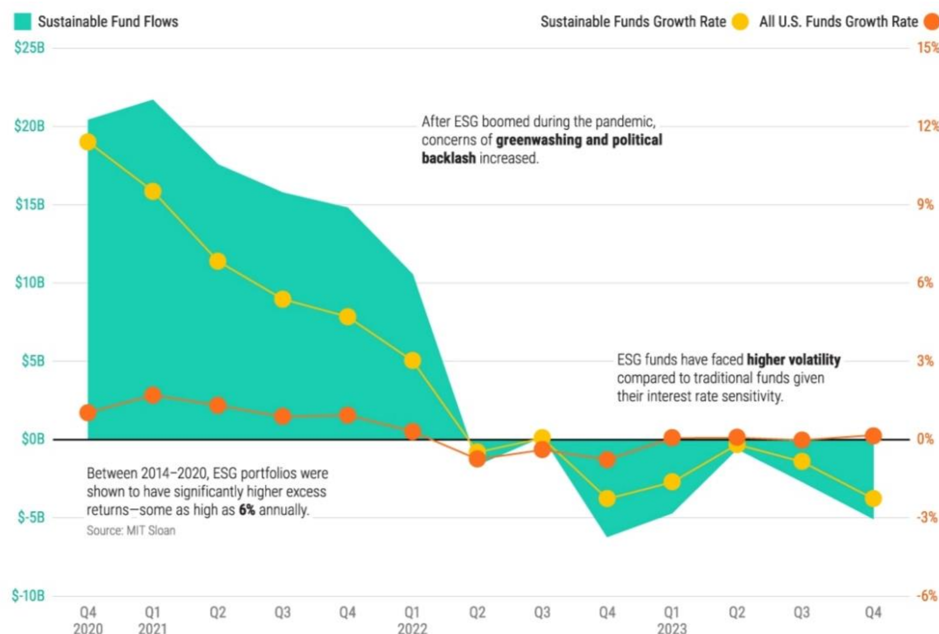

Figure 1.US Sustainable Fund Flows
Source: Morningstar Direct, Manager Research, Data as of Dec 31, 2023.

The chart above shows how flows into sustainable or ESG (Environmental, Social, Governance) investing have shifted from a strong boom during the pandemic to a more steady decline, reflecting challenges such as concerns about greenwashing, political uncertainty, and market volatility. The growth rate of sustainable funds has also declined, indicating a waning or more selective investor interest in ESG investments. According to Morningstar (2018), portfolios using a sustainable investment approach had $23 trillion in AuM (Assets under Manager) in 2017. AuM is the total market value earned each time an investor entrusts their investment to an Investment Manager. The compound annual growth rate of all ESG assets as part of global AuM is growing even faster than passive assets, which have significantly increased over the past few years.(Almeyda & Darmansya, 2019).

This issue has prompted several studies to explore the relationship between ESG performance and corporate financial performance. Previous studies on How Environmental, Social, and Governance Factors Affect Financial Performance have shown mixed results. The first study, namely(Guido et al., 2019)I researched "Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk, and Performance", which examines the relationship of companies with strong ESG to corporate financial performance. The study shows a positive association between environmental, social, and governance (ESG) attributes and business financial performance. Other research(Kacperczyk & Hong, 2011)This supports the findings of this study and concludes that entities with high ESG ratings are less likely to experience serious incidents such as fraud, embezzlement, corruption, or litigation cases, thereby maintaining the stability of the organisation's financial performance. Further research was conducted by(Melas et al., 2017)It is related to "Factor Investing and ESG Integration", which examines the impact of ESG on stock portfolio performance as a representation of a firm's value. The study shows a negative correlation between the company's value components and the ESG index. In contrast to(Qureshi et al., 2020)In his study entitled "The Impact of Sustainability (ESG) Disclosure and Board Diversity on Firm Value: The Moderating Role of Industry Sensitivity", he states that sustainability disclosure (ESG) is relevant to company value and has a positive impact on stock prices on the stock market. This argument is then supported by a study conducted by (Maaloul et al., 2023), which reveals a positive influence of ESG disclosure on corporate reputation. Due to differences in research results, a research gap needs to be filled to gain a deeper understanding of how ESG affects corporate financial performance, especially stock prices. One of the main gaps is the lack of uniformity in the methodology used to measure ESG performance, which can lead to differences in results and interpretations. In addition, most existing studies focus more on developed markets, so there is a need to examine the impact of ESG in various geographic contexts, including emerging markets with different dynamics.

In this literature review, the author will examine various studies to assess how ESG factors affect stock prices and corporate financial performance. This literature review aims to identify and analyse existing research on the relationship between ESG and stock prices, understand the factors that play a role in this relationship, and fill the existing gaps by providing a more comprehensive and holistic perspective. Thus, this study will provide valuable insights for companies, investors, and policymakers in understanding the importance and implications of ESG performance on corporate financial performance.

LITERATURE REVIEW

CSR and ESG

According to the United Nations Industrial Development Organization (UNIDO), Corporate Social Responsibility is a management concept that shows that companies integrate social and environmental issues into business activities. The concept of CSR concerns the organisation's response to the challenges of Sustainable Development Goals (SDGs). However, many companies fail to adopt a long-term strategic approach to CSR. (Kaźmierczak, 2022). This raises new suggestions for developing the CSR concept. There has been a dynamic change from the CSR concept to ESG (Environmental, Social and Governance), which is expected to be the best solution. ESG is an investment philosophy that focuses on long-term value growth that reviews 3 (three) aspects, including economic, social, and

governance(Ting Li et al., 2021). With ESG recognition, the positive relationship between Company value and operational performance becomes more muscular and persists in the long term. (Hassel, 2013).

Stock Price

Stock prices are a very reliable indicator of economic activity because they directly impact economic activity.(Pearce, 1983)Stock prices fluctuate due to several factors, including company performance, macroeconomic conditions, market sentiment, government regulations, industry performance, currency exchange rate fluctuations, investor perceptions, geopolitical conditions, and technological changes.(Brennan, 2011)Investors are interested in the growth of the Company's business, as reflected in the price of shares in circulation. The higher the price of the Company's shares indicates the company's good condition so that it can guarantee the dividends received by investors.(Gordon, 2013).

Legitimacy Theory

Legitimacy theory emerged, assuming an organisation has no natural right to exist.(Magness, 2006)Legitimacy theory explains the Company's reaction to threats to its legitimacy in relation to the social contract, such as voluntary environmental disclosure, especially in publishing annual reports, as a mechanism for the Company to meet external demands for stakeholders.(Mobus, 2005)Legitimacy theory states that organisations should appear to consider the rights of society at large, not just the rights of shareholders. If an organisation does not demonstrate appropriate behaviour, society should act to revoke the company's operating rights.(Savage et al., 2001).

Stakeholder Theory

Freeman et al. (2007) stated that stakeholders focus on the value and improving the company's performance. Freeman (1984) also previously stated that stakeholders are related to the company's actions in fulfilling their interests. Stakeholder theory can be described as a theory that (i) encourages organisations to recognise and consider their stakeholders, both from an internal and external perspective, (ii) encourages understanding and management of the needs, desires, and demands of these stakeholders, and (iii) provides a broad and responsible framework that goes beyond the focus of shareholders in the decision-making process, and (iv) allows organisations to make better decisions.(Mahajan et al., 2023).

According to Friedman (2006), organisations should be considered stakeholder groups. Therefore, organisational goals must regulate stakeholders' interests, needs, and perspectives. This statement is supported by the argument from (Kusumaningtias et al., 2016) that organizations have the right and should prioritize stakeholders because they contribute to profits. Furthermore, Friedman (2006) means a clear relationship exists between the definition of what stakeholders are and the identification of who the stakeholders are. The primary stakeholder groups are customers, employees, local communities, suppliers, distributors, and shareholders. To achieve long-term success in an organisation, managers must treat their stakeholders according to stakeholder theory, such as maximising profits and shareholder value. (Kaler, 2006). Eccles, RG, & Serafeim, G. (2013), in their research entitled "The Performance Frontier: Innovating for a Sustainable Strategy." Harvard Business Review. It states that companies can balance sustainability goals and financial performance, showing that attention to ESG can improve reputation and stakeholder relationships and provide better access to capital.

Signaling Theory

Signalling theory emphasises that people in an organisation often perform specific actions to show outsiders that they have good qualities that may not be immediately apparent.(Connelly et al., 2011)Signalling theory suggests that the benefits of relationships between organisations are often influenced by how they provide information to each other, including the general market conditions.(Reuer et al., 2012). By distributing dividends, companies try to convince investors that they are trustworthy and have good financial prospects, even though not all information is available to the public.(Dionne & Ouederni, 2011). On the other hand, Investors can invest funds in companies or projects that focus on reducing adverse environmental effects.(Mai et al., 2021).

METHODS

This research is a comprehensive analysis of various relevant sources. The approach used in this research is a Comprehensive Systematic Literature Review (SLR), a type of literature review that collects and analyses previous research studies thoroughly through a systematic process.(Cruz-Benito, 2016). SLRs are created by synthesising scientific evidence to answer a specific research question and analysing all published evidence.(Lame, 2019). In conducting a systematic review, a search strategy must be created to identify all studies that address a specific question.(Nightingale, 2009)The research data sources were collected through previous literature reviews with discussion qualifications on ESG, Stock Prices, and Corporate Financial Performance through scientific literature with a good reputation. The search was conducted on search engines such as Science Direct, Publish or Perish, and Google Scholar. From the search results, 15 articles relevant to the research topic were found published between 2016 and 2024.

RESULTS

Based on the literature review, 15 articles were identified and collected according to the previously established criteria. These articles were selected based on their relevance to the research topic, the quality of the methodology used, and their contribution to a deeper understanding of the issue under study. Exclusion criteria were applied to ensure that only relevant, valid, and reliable studies were included, while studies that did not meet these standards were excluded from further analysis. Thus, the collection of articles in the following table reflects a selective choice to provide a strong foundation for the analysis and synthesis of the data.

Table 1. Results of Literature Review

No.	Authors	Variable	Results of Research
1.	(Torre et al., 2020)	Independent: ESG Components Dependent: Stock Returns	The results found show that the performance of Eurostoxx50 companies does not appear to be influenced by ESG commitments.

2.	(Quintiliani, 2022)	Independent: ESG Score Dependent: Company Performance and Market Performance	The findings show a significant relationship between a company's stock price and ESG score.
3.	(Berg et al., 2016)	Independent: ESG Ratings Dependent: Stock Returns and ROE	- The findings show positive returns for high ESG stocks. - Investors determine ESG ratings to build ESG portfolios. Asset pricing depends on the portfolio type.
4.	(Dorfleitner & Zhang, 2024)	Independent: ESG News Dependent: Stock Price Reaction, Stock Performance, and Stock Markets.	- Market reactions to positive ESG News and negative ESG News are asymmetric. - Positive ESG News positively influences stock prices, while negative ESG News has a more substantial and negative influence on stock performance.
5.	(Wang et al., 2024)	Independent: ESG Ratings Dependent: Stock Performance	The findings of the study were that ESG ratings showed a significant negative impact on stock performance.
6.	(Larsson et al., 2022)	Independent: ESG Scores Dependent: Stock Prices	The study results show that companies that invest in CSR have more benefits for companies with a better reputation.
7.	(Kvam et al., 2024)	Independent: ESG Scores Dependent: Stock Returns and Company Level	This study's findings are that the ESG Index and stock returns show negative coefficients, so companies with the highest ESG scores experience the lowest returns, indicating that sustainable companies provide lower returns.

8.	(Derrien et al., 2022)	Independent: ESG News Dependent: Future Cash Flows and Firm Value	- Negative ESG News indicates an expectation of declining future sales rather than increasing production costs. - Quantitatively, it can explain the negative impact of ESG News on Firm Value.
9.	(Engelhardt et al., 2021)	Independent: ESG Rating Dependent: Stock Performance	- From a company perspective, engaging in ESG significantly pays off in terms of better stock performance. - From an investor's perspective, good ESG quality is an essential factor for a company's stock performance, especially during times of crisis.
10.	(van der Beck, 2021)	Independent: ESG Flows Dependent: Stock Price, ESG Portfolio	The study's results show that, with the implementation of ESG, the prices of green stocks will continue to increase, resulting in positive returns.
11.	(Giese & Nagy, 2018)	Independent: ESG Ratings Dependent: Equity Valuation, Risk, Financial Performance	Companies' ESG information influences their valuation and performance through their systematic risk profile (lower cost of capital and higher valuation) and their idiosyncratic risk profile (lower cost of capital and higher valuation).
12.	(Breitz & Partapuoli, 2020)	Independent: ESG Scores Dependent: Stock Returns	The results show that portfolios with low ESG scores outperform the market and with higher scores, where the impact of the environmental pillars differs.

13.	(Rzeznik et al., 2023)	Independent: ESG Ratings Dependent: Stock Prices Performance	The research results did not find any influence on stock portfolio balancing or investor flows. Companies react to changes in ESG ratings and abnormal returns by issuing or buying back shares.
14.	(Kirkerud & Tran, 2019)	Independent: ESGScore Dependent: Stock Prices	The research results show that ESG Scores are reflected in stock prices in Europe and contribute with relevant information on sustainable investment for managers, investors and stakeholders.
15.	(Cornell, 2020)	Independent: ESG Investing Dependent: Portfolio Construction	Research findings suggest that greater disclosure of information regarding the environmental impacts of corporate operations has the potential to benefit shareholders, regulators and other corporate stakeholders,

Source:*Author's compilation*

DISCUSSION

Based on the collected findings, the author reviews the results of previous research in a substantive discussion to deepen the results of this study.

ESG and Financial Performance

As awareness of the importance of sustainability and social responsibility increases, many companies increasingly integrate Environmental, Social, and Governance (ESG) principles into their business strategies. ESG focuses on profitability and the broader impact on the environment, society, and good corporate governance. However, how does ESG affect a company's financial performance? Can companies that implement ESG practices increase their value and profitability?

ESG plays a critical role in shaping investor perceptions and corporate strategy. While there is no universal causal relationship between ESG and financial performance, evidence suggests that good management of ESG factors can contribute to better long-term performance by reducing risk and enhancing reputation. As awareness of the importance of sustainability grows, companies that fail to adopt good ESG practices may face more significant risks related to regulation, litigation, and loss of trust from investors and consumers.

Many studies have shown that companies with good ESG performance have better financial performance. For example, a study by Friede, Busch, and Bassen (2015) that analysed more than 2,000 empirical studies found that most studies (around 90%) showed a positive relationship between ESG performance and financial performance. These results indicate that

companies that manage environmental, social, and governance risks will tend to generate higher and more stable stock returns. Another study by Eccles, Ioannou, and Serafeim (2014) showed that companies that consistently implement sustainability practices (sustainability-focused firms) have better financial performance in the long term compared to companies that do not focus on sustainability. This study shows that companies implementing good ESG are more likely to attract and retain customers, reduce operating costs, and minimise reputational risk.

One of the main ways ESG practices can impact financial performance is through the cost of capital and access to investment. Research by Bauer and Hann (2010) found that companies with higher environmental risks tend to face a higher cost of capital, as investors perceive them as riskier. Conversely, companies with high ESG scores tend to have a lower cost of capital because investors perceive them as safer and more sustainable investments. On the other hand, institutional investors, such as pension funds and sovereign wealth funds, are increasingly considering ESG criteria in their investment decisions. This incentivises companies to improve their ESG scores to attract this type of investment. According to the Global Sustainable Investment Review (2020), assets under management using sustainable investment strategies reached over $35 trillion globally, increasing investor demand for socially and environmentally responsible business practices.

Research by Delmas and Burbano (2011) found that greenwashing can damage a company's reputation and reduce investor confidence if it is revealed that actual actions do not support its sustainability claims. In addition, there is no universal standard for measuring ESG performance, which can lead to inconsistencies in ESG assessments across companies. This can make it difficult for investors to compare ESG performance effectively. However, efforts to develop more uniform ESG reporting standards, such as those undertaken by the Sustainability Accounting Standards Board (SASB) and the Global Reporting Initiative (GRI), are expected to mitigate these challenges.

Previous research shows that good ESG practices benefit the environment and society and can improve a company's financial performance. Companies serious about implementing ESG can enjoy better returns, lower capital costs, and a better investor reputation. However, companies must ensure that their ESG efforts are authentic and substantial to avoid the risk of greenwashing. For stakeholders, including investors and policymakers, it is essential to encourage transparency and accountability in ESG practices. Thus, ESG can be an effective tool to improve a company's financial performance while positively contributing to global sustainability.

How ESG Factors Influence Stock Prices?

Environmental, Social, and Governance (ESG) has become one of the most discussed topics in modern investment. As awareness of sustainability and social responsibility increases, investors increasingly consider ESG criteria in their investment decisions. How do these ESG factors affect stock prices? Environmental factors include carbon emissions, energy use, waste management, and other sustainability practices. Research by Friede et al. (2015) shows that companies with good environmental scores tend to experience increased stock prices. This is due to two main reasons: (i) Reputation and Investor Trust. Companies that care about the environment usually have a better reputation in the eyes of the public and investors, which can increase trust and ultimately drive stock prices up. (ii) Reduced Regulatory Risk: Companies with sound environmental practices tend to be better prepared

for increasingly stringent regulatory changes related to the environment. This reduces the risk of litigation or fines, which can positively impact stock prices.

Social factors relate to how a company interacts with employees, customers, communities, and other stakeholders. This includes human rights, employee welfare, and community involvement. Research by Waddock and Graves (1997) found that companies with good social practices, such as providing decent working conditions and contributing to the community, tend to have better stock market performance.

Governance factors include board structure, transparency, accounting practices, and risk oversight. Research by Gompers, Ishii, and Metrick (2003) shows that companies with good governance tend to have more stable and profitable stock price performance.

A meta-analysis by Friede, Busch, and Bassen (2015), which analysed more than 2,200 empirical studies, showed that 90% of the studies found a positive or neutral relationship between ESG performance and corporate financial performance, including stock prices. This suggests that focusing on ESG is not just a trend but a sustainable and potentially profitable investment strategy. In addition, research by Khan, Serafeim, and Yoon (2016) highlighted that the impact of ESG on stock prices can be more substantial in industries that are more exposed to environmental and social risks, such as energy and manufacturing. This suggests that the sensitivity of stock prices to ESG factors can vary depending on the industry sector.

The increasing attention to ESG reflects changing societal values and aligns business interests with long-term sustainability. Companies that integrate ESG factors into their business strategies can benefit from a good reputation, increased stock prices, and financial stability. While challenges remain, such as potential greenwashing and consistent measurement, empirical evidence suggests that focusing on ESG can be profitable for companies and investors. Through a responsible environmental, social, and governance approach, companies can build stronger relationships with stakeholders and increase their long-term value in the stock market.

CONCLUSION

Based on the systematic literature review that has been conducted, research on the influence of Environmental, Social, and Governance (ESG) on stock prices shows varying results, both positive and negative. Several studies have found that implementing good ESG practices can increase the value of a company's shares, reflecting investor confidence in the sustainability and social responsibility of the company. Conversely, other studies indicate that negative ESG news or practices can decrease stock prices, mainly if investors assess reputational risk or potential additional costs in the future. However, several studies have also found that the influence of ESG on stock prices is not always consistent and can vary depending on the industry, company policy, and investor perception. Although evidence supports the positive influence of ESG performance on stock prices, the mixed results indicate that other factors, such as market conditions and company strategy, also play an essential role in determining stock values related to ESG issues.

This study has several limitations that need to be considered. First, most studies analysed in this review are from developed countries, so the results may not be entirely relevant or applicable to emerging markets. Second, the measurement methods and definitions of ESG vary across studies, which may affect the consistency of the results. Furthermore, the data in these studies are often retrospective, which may not capture

dynamic changes in ESG practices or investor perceptions over time. Finally, this study does not account for other external factors affecting stock prices, such as regulatory changes or macroeconomic conditions.

Future research is recommended to expand the geographic scope by including more data from emerging markets to understand the impact of ESG in a broader global context. Future research should also use a more uniform definition and measurement method of ESG to improve the comparability of results across studies. In addition, longitudinal studies that analyse changes in investor perceptions of ESG over time would provide deeper insights. Combining ESG data with other external factors, such as regulatory changes or economic conditions, could also provide a more complete picture of the impact of ESG on stock prices.

The findings of this systematic literature review have several important implications. For companies, these results suggest that investing in good ESG practices is not only relevant for social and environmental responsibility but can also positively impact the company's stock value, increasing the company's attractiveness to investors. For investors, these findings emphasise the importance of considering ESG factors in investment decision-making to identify companies with sustainable long-term growth potential. Finally, for policymakers, these results highlight the need for a clear and consistent regulatory framework on ESG practices to promote transparency and accountability and to help guide companies towards more sustainable business practices.

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