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# CONCEPTUALISING ENVIRONMENTAL, SOCIAL, AND GOVERNANCE LINKING WITH FINANCIAL LEVERAGE AND CORPORATE FINANCIAL PERFORMANCE

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**Abstract:** Environmental, social, and governance (ESG) performance is used by businesses to increase their financial resilience in reaction to an ever-more volatile business setting and threatening long-term sustainability contexts. This is a conceptual review study to explore the effects of financial leverage on the relationship between ESG performance and corporate financial performance. This study adopts re-examining the indirect effects of financial leverage, the foundation of corporate ESG performances, and its influences on corporate financial performance from the course of existing and prominent research works and literature. The study reveals that corporate Environmental(E), Social(S), and Governance(G) performances influence better financial performance irrespective of sectors, states, and regions with some minimal exceptions. Moreover, ESG performance positively affects the sources and costs of financial leverage which promotes increasing corporate financial performance. These findings are consistent with previous research on the rising value of corporate ESG performance, financial leverage, and the positive and mediating effects of firms adopting an ESG strategy on corporate financial performance.

**Keywords:** Financial leverage, Environmental performance, Social Performance, Governance performance, corporate financial performance.

## 1. Introduction

Global environmental disasters, corporate social issues, and a lack of good governance have become important issues in recent decades, putting the globe in upheaval and interfering with sustainable growth (Khaled, et al., 2021). Among the issues that have put the world environment and socio-economic progress at dire risk include climate change, excessive extraction of natural resources (Knap & Rusyn, 2016), community and consumers protection, employer-labor relationships (Giulianotti, 2015); governance scandals such as Schwarcz (2002) and 2016 Bangladesh Bank reserve heist (Mazumder & Sobhan, 2020). Recognising the importance, the idea of environmental, social, and governance (ESG) has been introduced in 2005 (Kell, 2018) brought together institutional investors, asset managers, research analysts, global consultants, corporate and government bodies, and regulators to investigate the role of ESG values in socio-economic development at national and international level (International Finance Corporation [IFC], 2005). Thus, ESG acquired great attention to corporate sectors that are necessary to enhance corporate performance, capital structure decision-making, mitigate risks, and sustainable development (Huang, 2021). As a result, ESG performance has sparked the interest of stakeholders and academics in both developed and developing nations.

The corporate performance involves all categories of stakeholder intimation, and it represents an essential initiative to control and implement long-term strategies for sustainable growth. Poor financial performance of the business can cause tremendous pressure on the declining market, lack of customer confidence, governance issues, competitive edge, increasing cost, and overheads, lack of sales growth, creating unexpected financial risk, especially credit risk, market risk, and liquidity risk, and non-financial risks such as operational risk, business or strategic risk, and reputational risk, etc. (Ali & Oudat, 2020). In such situations, companies suffer to manage the volatile and vulnerable situations for financial indicators such as Return on Assets (ROA), Return on Equity (ROE), Return on Sales (ROS), Return on Invested Capital (ROIC), Earnings Per Share (EPS) and overall market performances (Phuong & Binh, 2022).

Furthermore, non-financial issues relating to environmental and social issues such as inefficient resource utilisation, emission management, human rights issues workplace safety, and product responsibilities also arise stakeholder conflicts and lack of competitive advantages over competitors that create vacillations in corporate financial performance (Xuemei, et al., 2019). The lack of good governance practices ignites agency conflicts between shareholders and management that impact corporate financial performance (Yameen, et al., 2019; Al-Ahdal, et al., 2020). Apart from the above reason, the common causes of unsustainable revenue or profit performance include poor strategy or execution, lack of talent or resources, and poor marketing and communication (Hinton, 2021). Most importantly, liquidity risk induces idiosyncratic financial constraints and lower corporate financial performance in the form of a lack of stakeholder confidence, lower adjustments of leverage, reduction in expansion marketing, and development, and lack of sustainable financial sources (Kocaarslan & Soytas, 2021).

However, while corporate environmental performances ensure the use of resources more efficiently and reduce wastage and pollution, implement greener and more efficient technologies (Sang & Zhichuan, 2021), corporate social performances ensure product responsibility, community participation and development, employment quality, health and safety, and worker training and development (Carroll, 2021). Moreover, corporate governance performances ensure the best management principles and practices, board and shareholders value, ESG integration framework, etc. Additionally, ESG performances influence corporate financial leverage position (Kung-Cheng, et al., 2021), and consequently, companies with better ESG performance help to increase the financial performance of companies (Gadzo & Asiamah, 2018). Moreover, the ESG complied companies enjoy efficient productivity, stakeholders' confidence, competitive advantages, and reduced information asymmetry. As a result, better ESG complied companies face lower capital constraints, and lower cost of funds for leverage that helps in better cash flow, liquidity management, tax shield, and new profitable investments. Therefore, this paper reviews the empirical literature on ESG and aims to construct a conceptual framework for the effects of financial leverage on the relationship between ESG and corporate financial performance.

## 2. Literature Review on ESG

ESG is a process of conveying the corporation's environmental, social, and governance aspects to specific interest groups inside communities, as well as to society as a whole (Sang & Zhichuan, 2021). Hence, ESG entails organisations especially enterprises going beyond their conventional responsibility of presenting a financial report to capital owners, notably shareholders. This expansion is based on the premise that businesses have broader duties to stakeholders than just making money for their shareholders. ESG is commonly used by stakeholders and investors to evaluate company actions relating to environmental, social, and governance issues. ESG variables are, also called non-financial performance indicators, and are used to detect concerns connected to business ethics, corporate social responsibility, and corporate governance (Sultana, et al., 2018; Duque-Grisales & Aguilera-Caracuel, 2021).

The overall performance of a corporate today includes its performance along different non-financial dimensions of sustainability using the ESG performance construct which is a multidimensional and complex construct with ambiguity and pluralistic goals driven by contextual context and emphasises a company's responsibilities and its responsiveness towards its multiple stakeholders. The overall ESG performance has a direct or indirect financial influence on the entity's profitability and investment returns, and the impacts of ESG on the financial performance of firms are justified (Ahmad, et al., 2021). In a meta-analysis, Friede et al. (2015) observed that around 90% of 2200 studies showed positive and non-negative relationships between ESG and corporate financial performance (CFP) over the period from the 1970s to the 2015s. In another meta-analysis, Whelan, et al. (2021) found around 92% of 1000 empirical studies with non-negative ESG-CFP relationships from 2015s to 2020s. For this reason, nowadays, ESG performances are considered as three pillars of better corporate performance and sustainability (Zumente & Bistrova, 2021).

### *2.1 Corporate Environmental Performance and financial performance*

Corporate Environmental Performance (CEP) refers to a company's responsibilities and capacity to choose responsible activities to establish and preserve a naturally or ecologically friendly environment (Shah, et al., 2016). It represents environmentally friendly business strategies such as waste reduction, effective resource use, environmentally friendly green innovation, and processes for stakeholder interest preservation and management (Trumpp, et al., 2015). The corporate's environmental performance includes its efforts to use resources more efficiently, lower the environmental impact of its activities, implement greener technologies, and enhance the environmental stewardship in which it operates (Ifada, et al., 2021). The reduction of environmental degradation caused by corporate action, as well as the improvement of the environmental performance, are indicators of a company's environmental performance, and they have received increased attention from society, requiring companies to reduce their harmful impact on the environment and contribute to long-term development (Féres & Reynaud, 2012).

Corporate enterprise uses resources and generates pollution and waste, which can degrade natural systems and cause irreversible harm, diminishing the quantity of environmental resources available to society. Corporate environmental measures that have a financial impact must be implemented to avoid and decrease environmental harm (Albertini, 2013). As a result, businesses must reduce and regulate their use of natural resources and energy, as well as eliminate pollution and waste generation during and after the manufacturing process. Businesses may also create creative, environmentally friendly, or green goods to lessen their environmental effect (Misani & Pogutz, 2015). Adoption and implementation of environmental measures may have varying effects on a company's financial performance, providing a new explanatory component to the link between CEP and CFP (Manrique & Martí-Ballester, 2017). By applying good environmental practices, corporations may acquire a competitive advantage based on pollution avoidance, product stewardship, and proper management of natural resources and capabilities assures businesses' financial performance (Waddock & Graves, 1997; Lioui & Sharma, 2012).

Resource reduction reflects a company's ability to reduce the use of materials, water, and energy, as well as improve supply chain management by implementing more eco-efficient manufacturing solutions that measure management's commitment and effectiveness in achieving efficient use of natural resources in the manufacturing process. Furthermore, emission reduction assesses a company's commitment and effectiveness in reducing environmental emissions in manufacturing and operational processes, and reflects the company's ability to reduce air emissions (e.g., greenhouse gases), hazardous waste, water discharges, or biodiversity impact, as well as partner with environmental organisations to mitigate the company's impact in the community. Product innovation assesses a company's commitment and effectiveness in supporting the research and development of environmentally friendly products and services, as well as its ability to reduce environmental costs and burdens for customers, and to create new market opportunities with new environmental technologies/processes and dematerialised, eco-designed products that last longer (Manrique & Martí-Ballester, 2017).

Environmentally conscious businesses may incur less regulatory costs, thereby opening up more economic prospects as demand for greener products expands. Green innovation may either reduce the cost of pollution after it has occurred or improve productivity and efficiency to prevent pollution from occurring in the first place (Shenggang, et al., 2020). Furthermore, environmental stewardship serves as a conduit for technical skills, and compliance with green legislation necessitates the creation and acquisition of new technologies to provide favourable conditions for businesses to achieve financial success (Ramanathan, 2018). Corporate environmental performance may promote profitability by increasing stakeholder trust, establishing a competitive advantage, and employing resources more efficiently by cutting green costs and increasing sales to achieve financial success (Khojastehpour & Johns, 2014). The relationship between corporate environmental performance and corporate financial performance can be visualised as follows:

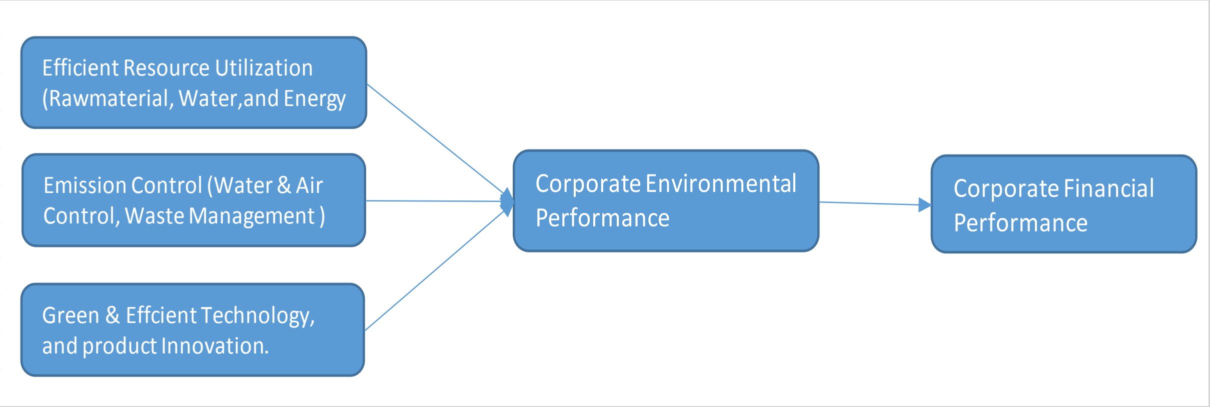
Efficient Resource Utilization (Rawmaterial, Water,and Energy
Emission Control (Water & Air Control, Waste Management )
Green & Effcient Technology, and product Innovation.
Corporate Environmental Performance
Corporate Financial Performance

Figure 1. Corporate Environmental Performance Linking with Corporate Financial Performance

### *2.2 Corporate Social Performance and Financial Performance*

While corporate social performance is defined as a corporate organisation's development of social responsibility ideas, processes, policies, projects, and quantitative outcomes relating to the company's social relations (Tarmuji, et al., 2016). Corporate Social performance is regarded as a concept that emphasises a company's duties to several stakeholders, such as workers and the society at large, in addition to its traditional responsibility to economic shareholders. As a result, organisations with great social performance have an easier time acquiring qualified employees (Greening & Turban, 1996, 2000). As a result, to foster trust and loyalty among its workers, customers, and society, the company should be socially responsible and responsive to social problems. A company's social responsibility may be measured by its product responsibility, community participation, and development, human rights, diversity and opportunity, employment quality, health and safety, and worker training and development (Agudelo et al., 2019; Carroll, 2021).

Corporate social efforts improve employee well-being and motivation. They can and do aid in the ease of hiring good individuals, as well as staff retention, devotion, and inspiration, all of which contribute to increased creativity and productivity. Motivated employees are less likely to look for jobs elsewhere (Mei & Spong, 2021), and more exceptional people want to work for firms that do not exploit their personnel. Employees on the front lines are also best placed to identify inefficiencies and provide remedies (Sharma, et al., 2020). Corporate social performance is the voluntary incorporation of social and ethical values into company activities. Businesses are responsible for their social consequences, and as a result, they must address not only financial but also greater societal goals (Ramasastry, 2015). Corporate social performance focuses on the links between human rights and due diligence which is a necessary technique for enterprises to learn about and demonstrate their commitment to human rights) and legal compliance, including corporate governance and securities legislation (Ramírez-García & Spelz, 2020). One of the social principles and aspirations is respect for the rights of stakeholders affected by their operations, and as a result, human rights are an essential component of social performance. According to Buhmann (2011), human rights are a component of CSR since they are prominently included in social performance policies and philosophies.

Furthermore, one component of corporate social performance (CSP) is community engagement, which allows members of the public to express their concerns about corporate operations and collaborate with the firm in its efforts to achieve long-term success. This involvement also helps the company to hear and resolve community complaints regarding corporate actions, as well as satisfy their expectations (Chun-Keung, et al., 2018). A CSR-compliant organisation assesses the existing and future environmental, community, and societal impacts of its commercial operations (Deigh, et al., 2016). Sponsorship, charity, employee volunteers, collaboration with non-profit organisations (NPOs), and environmental preservation and energy efficiency initiatives were formerly examples of social efforts. The activities were dispersed and disconnected from the main company, and they were labelled as "feel-good" product responsibility.

A multitude of issues, including activist campaigns, enhanced transparency, and regulatory constraints, have driven businesses to implement a systematic business-aligned social integration approach (Hickle, 2017). Corporate social performance strengthened the present product-development triangle of desirable, practical, and viable with socially responsible components. It is no longer adequate to focus on designing goods that are appealing to buyers, viable to manufacture, and financially sustainable for businesses. Furthermore, society demands socially responsible items (Calveras & Ganuza, 2018). The social pillar assesses a company's ability to promote trust and loyalty among its employees, customers, and society through best management practices. It depicts the state of the company's operating licence, both of which are critical elements in determining the company's ability to produce long-term value for shareholders through financial success. Figure 2 below demonstrates the relationship between corporate social performance and financial performance.

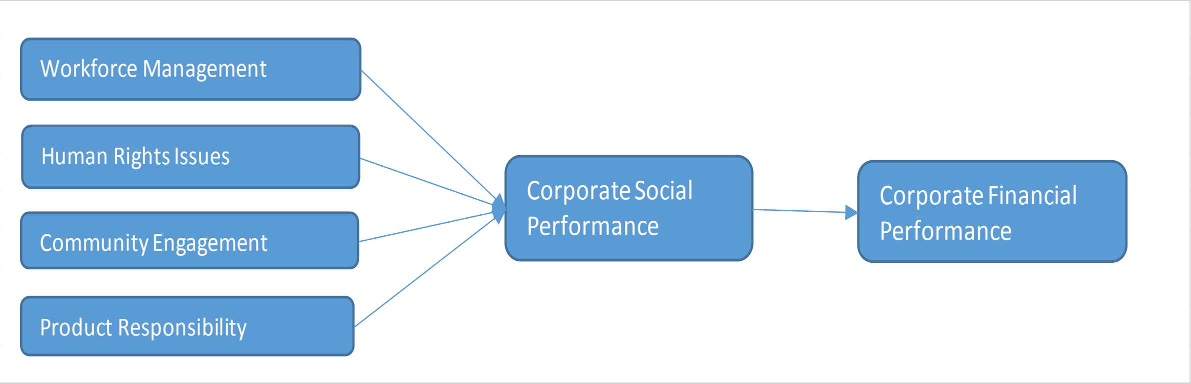

Figure 2. Corporate Social Performance Linking with Corporate Financial Performance

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### *2.3 Corporate Governance Performance and Financial Performance*

The performance of a company's corporate governance reflects how well it manages its affairs. The corporate governance pillar assesses a company's policies and practices to ensure that its management body, such as board members and executives, is acting in the long run in the best interests of its shareholders. Furthermore, it indicates a company's ability to govern and regulate its rights and obligations through the development of incentives and checks and balances to build long-term shareholder value through the application of best management practices (Ahmad et al., 2021). A solid corporate governance structure is critical for maximising a company's performance in the best interests of its shareholders, reducing agency costs, and ensuring corporate survival (Fama & Jensen, 1983b).

The function of corporate governance in the execution of an organisation is to assist management in overseeing the company's activities. The vision and strategy, as well as economic (financial), social, and environmental indicators, should be discussed with all stakeholders and integrated into daily decision-making procedures (Ahmad et al., 2021). The CSR Strategy, which represents a company's activities to convey that it integrates the economic (financial), social, and environmental components into its day-to-day decision-making processes, is influenced by good governance practices (Tarmuji et al., 2016). Organisations must follow corporate governance policies and frameworks to be sustainable and progressive. Corporate governance responsibility means that the business has specific sustainability management procedures in place and has a significant impact on the organisation's financial success. The link between corporate governance and financial success is illustrated as follows;

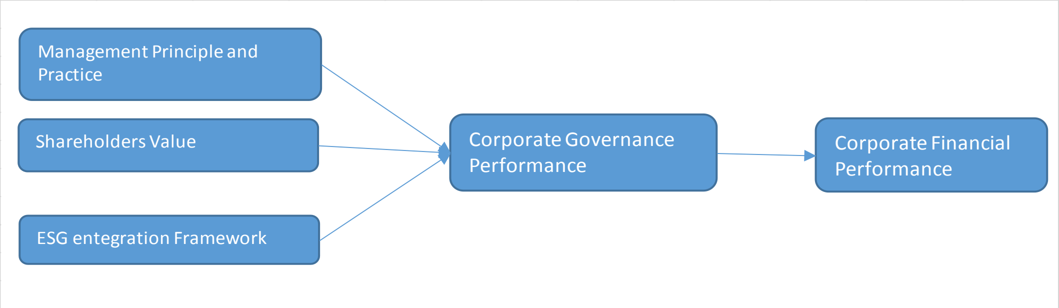
Management Principle and Practice
Shareholders Value
ESG entegration Framework
Corporate Governance Performance
Corporate Financial Performance

Figure 3. Corporate Governance Performance Linking with Corporate Financial Performance

## 3. Financial Leverage and Financial Performance.

In recent decades, investors, lenders, and other stakeholders throughout the world have extensively implemented ESG issues into their key business decisions (Ly, et al., 2021). A growing curiosity about the reasoning behind the non-financial performance of environmental, social, and governance (ESG) activities in business decisions undertaken by corporations exists (Limkriangkrai, et al., 2017).

Environmental (E) activities refer to a company's attempts to have a beneficial influence on the environment by adhering to present rules and anticipating future consequences. Social (S) activities relate to treating close stakeholders fairly and safeguarding the social ecosystem in which the company works.

In addition, governance (G) encompasses a high level of ethics and integrity, as well as concepts like openness and fair dealing, as well as the board of directors ability to work effectively. These non-financial ESG factors integrating economic growth, environmental protection, social justice, and governance have the potential growth to create value for companies by increasing financial performance, that is lowering the idiosyncratic financial constraints (Cheng, et al., 2014), reducing a firm's risk (Salzmann, 2013), and sinking the costs of capital (Kee-Hong, et al., 2019). Environmental, social, and governance performance accelerates the rate at which businesses shift their leverage toward the target capital structure and positions them to function at the optimal level of leverage, balancing the advantages of debt financing against the costs of debt financing (Kung-Cheng et al., 2021). Further, ESG factors are significantly associated with the speed with which firms adjust leverage toward their targets and consider target leverage ratios when they issue new capital to lower firm risks, reduce costs of capital, improve information transparency, enhance stakeholder engagement, and generate competitive advantage (Seong et al., 2013; Breuer et al., 2018).

## 4. Role of Financial Leverage on ESG and Corporate Financial Performance

Environmental, social, and corporate governance concerns are increasingly being used by institutional and individual investors to manage portfolios, which is an important component of socially responsible investment. This means that firms that incorporate ESG principles into their fundamental business strategy are more likely to receive funding from green financial markets rather than regular ones. These non-financial ESG variables, which include economic development, environmental preservation, social justice, and governance, can increase company value by improving financial performance, therefore eliminating distinctive financial restrictions (Cheng et al., 2014), reducing a firm's risk (Salzmann, 2013), and sinking the costs of capital (El Ghoul et al., 2018; Kee-Hong et al., 2019).

Environmental, social, and governance performance accelerates the optimal growth rate at which the leverage of businesses moves toward the target capital structure and prepares them to function at the optimal level of leverage, balancing the advantages of debt financing against the costs of debt financing (Kung-Cheng et al., 2021). Furthermore, ESG factors are significantly related to the rate at which firms adjust leverage toward their targets and take target leverage ratios into account when issuing new capital to reduce firm risks, lower capital costs, improve information transparency, increase stakeholder engagement, and generate competitive advantage (Breuer et al., 2018). Moreover, Companies with better ESG performance, actively protect the environment by efficient resource utilisation and innovation, caring for social responsibilities, improving governance issues, and emphasising the rights and interests of stakeholders. Therefore, better ESG complied companies face lower capital constraints, and lower cost of funds for leverage that helps in better cash flow, liquidity management, tax shield, and new profitable investments and increase the corporate financial performances.

## 5. Development of Conceptual Framework

According to previous studies, corporate non-financial ESG performance has a considerable effect on firm financial performance, while ESG accelerates long-term profitability and risk reduction in the context of environmental, and societal duties. Regarding corporate performance, ESG issues take into account a company's operational impact on the environment (for example, carbon emissions, resource use, energy use, water use, pollution control, and green innovation), society (for example, ethical trading principles, health and security, product safety, and charitable activities), and governance practices quality (accountability, board composition, and stakeholder protective measures) (Sultana et al., 2018). It is described as context-specific or non-financial company activities and policies that incorporate stakeholders' expectations including the triple bottom line of economic, social, and environmental performance. The components or dimensions of corporate E(Environmental), S(Social), and G(Governance) performance have been explored individually and together in this area of the research.

According to Zhang & Liu (2022), ESG factors integrate economic growth, protect the environment, create social justice, and develop good governance that has the potential to create value for companies by increasing financial performance, lowering distinctive financial constraints, reducing firm risk, reduce costs of capital, and helps to determine optimal leverage position in capital structure. It is observed that financial leverage ensures better cash flow, liquidity management, tax shield, and new profitable investments that help better financial performance. The above literature discussion portrays that the ESG dimension either differently or jointly has an impact on corporate financial performance. Moreover, ESG performance improves the capital structure propositions of the corporations and it also mediates on the financial performances. Hence, the mediating relationship of financial leverage between corporate ESG and financial performance is demonstrated in Figure 4.

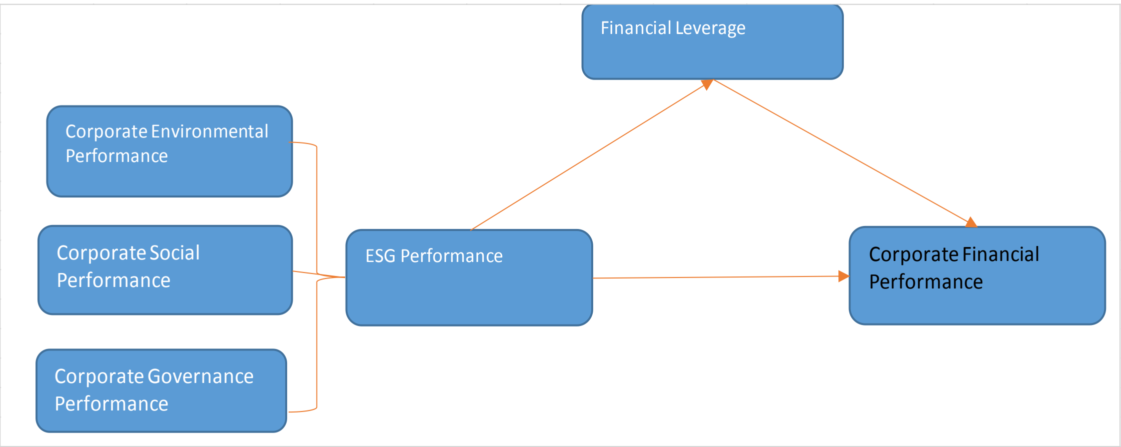
Financial Leverage
Corporate Environmental Performance
Corporate Social Performance
Corporate Governance Performance
ESG Performance
Corporate Financial Performance

Figure 4. A Conceptual Framework of ESG Performance and Corporate Financial Performance

## 6. Discussion

The influence of ESG criteria on CFP has long been a topic of academic, and practitioners' interest (Revelli & Viviani, 2015), while the predominant academic finding shows that there is a positive association between ESG and financial performance (Xiang & Xiang, 2019). Corporate ESG performance influences financial performance by influencing corporate competitive advantages, risk minimisation, consumer confidence, market reputation, investor attractiveness, employee satisfaction, ethical business, organisational efficiency and productivity, and sustainable development (Yumei et al., 2021). Furthermore, the belief that ESG activities will contribute significantly to stock price adaptability even in times of crisis is based on the findings that CSR activities help to build social capital and trust in the corporation and that these bonds, in turn, will help encourage the interested parties of the corporations (employees, customers, suppliers, financiers, government, society, and so on) to remain loyal, allowing the company to dissent (Demers, et al., 2021).

The environmental performance of the corporation comprises its attempts to use resources more effectively, reduce the environmental impact of its activities, offer greener technology, and improve the environmental stewardship in which it works (Ifada, et al., 2021). Reduced environmental degradation as a result of corporate action, as well as improved environmental performance, are indicators of a company's environmental performance, and they have received increased attention from society, requiring companies to reduce their harmful impact on the environment and contribute to long-term development (Féres & Reynaud, 2012). A company's social performance may be measured by its product responsibility, community participation, and development, human rights, diversity and opportunity, employment quality, health and safety, and worker training and development (Agudelo et al., 2019; Carroll, 2021).

The social aspect evaluates a company's capacity to foster trust and loyalty among its workers, customers, and society by implementing best management practices. It demonstrates the state of the company's operating licence, both of which are critical factors in determining its performance potential to generate long-term profit for shareholders through financial performance. Corporate governance performance evaluates a company's policies and processes to ensure that its board members and executives are operating in the best interests of its shareholders over the long term. Furthermore, it demonstrates a company's capacity to control and regulate its rights and duties through the creation of incentives as well as checks and balances to create long-term shareholder value through the use of best management practices (Ahmad et al., 2021).

A strong corporate governance framework is essential for increasing a company's performance in the best interests of its shareholders, lowering agency costs, and assuring corporate survival (Fama & Jensen, 1983a). The ESG integration framework, which represents a company's activities to convey that it integrates the economic (financial), social, and environmental components into its day-to-day decision-making processes, is influenced by good governance practices (Tarmuji et al., 2016). To maintain sustainability and to be more progressive, organizations adhere to corporate governance practices and structures. Corporate ESG performance indicates that the firm has specialised sustainability management practices in place and has a substantial influence on the financial success of the organisation.

## 7. Conclusion

Corporate financial performance represents an essential initiative to control and implement long-term strategies for sustainable growth. Widespread environmental disasters, corporate social issues, and a lack of effective governance have all emerged as major challenges in recent decades, fueling global turmoil and impeding sustainable performance. In this case, ESG performances have been extensively touted as catalysts for better and sustainable CFP, CEP, and ensure efficient resource utilisation of raw material, water, and energy, etc., emission control (water and air control, waste management, etc.), and green and efficient technology.

Corporate social performances ensure healthier workforce management, solving human rights issues, community engagement, and greater product responsibility, etc. Besides ESG performances help reduce liquidity risk and induce idiosyncratic financial constraints. Hence, financial leverage is heavily influenced by ESG performance and CFP. Thus, the ESG complied company enjoys efficient productivity, stakeholders' confidence, competitive advantages, reduced information asymmetry, and preserves investors' and lenders' confidence. Consequently, better ESG complied companies encounter lower capital constraints, and lower cost of funds for leverage that helps in better cash flow, liquidity management, and tax shield, hence increasing the CFP. Finally, it is exerted that financial leverage mediates the relationship between ESG performance and CFP.

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