THE ESG IMPACT ON FINANCIAL PERFORMANCE AT THE COMPANY LEVEL

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Abstract. *The object of this article is to present a concise study of the state of scientific literature regarding the relation between the Environmental, Social and Corporate Governance (ESG) factors and the financial performance at a company based level. According to scientific literature, we expect that the more socially responsible companies have an interest in the well-being of the stakeholders (customers, employees, members of the supply chain, and the community) as much as in that of their shareholders.*

Keywords*: sustainable finance; credit risk management; ESG; policy*

Introduction

In today's economy, commercial banks play a very important role in national financial systems. The profitability of commercial banks depends on how they manage their loans and assets. Thus, credit risk management is crucial in the banking system, representing the main activity of any commercial bank. But in this developing world, where climate and social factors are starting to play an increasing role in the business sector, environmental, social, and governance (ESG) criteria have become part of the crucial factors considered a consideration when designing the risk framework that will be applied to a particular client. Institutions and their management must adapt their sustainable environmental policies and procedures in the context of their objectives strategy and general sustainable finance policy. Institutions must set qualitative and, where appropriate, quantitative objectives. High-profile ESG programs tend to be launched and developed primarily by organizations that integrate them into evolving business models and strategies, thereby gradually translating into sustainable strategic management frameworks.

The present paper explores the current challenges of sustainable strategic management in the banking sector in parallel with regulatory requirements, investigating the relationship with available practices considering two major challenges currently reshaping the sector: digitalization and sustainability requirements. It is proposed to determine the relationship between ESG, strategic management initiatives, and organizational performance considering regulatory requirements and determine if there is any significant correlation between the variables. This paper contributes to the literature in the field by researching and analyzing ESG and its purpose is to show that if the number of companies that adopt ESG norms increases, this will lead to an increase

in the financial position of the companies and make a potential better client from these companies for financial institutions as well as their partners.

From a theoretical and applied point of view, this paper addresses a new topic and aims to understand the correlation between financial indicators and (ESG) performance in banking and companies. Another important aspect is the analysis of long-term economic growth potential for possible customers, which can be done by easily comparing different business sectors. At the same time, this study offers a new perspective to approach how environmental, social, and corporate governance factors influence the creditworthiness of a potential customer or business partner.

In essence, corporate social responsibility (CSR) acts as a self-regulating business model that raises awareness of a company's social responsibility to all stakeholders (itself, stakeholders, and the public). By applying the principles of corporate social responsibility, companies can be aware of their impact on the society in which they operate, including economic, social, and environmental factors. Applying (CSR) principles is defined as practicing in the ordinary course of business, ways that increase the development and responsibility of society and awareness related to the state of the environment, instead of having a negative impact on their state. CSR recommendations are considered by most specialists to be the forerunners of environmental, social, and governance (ESG) recommendations, but the two are far from interchangeable. While (CSR) aims to increase business responsibility, (ESG) criteria measure the company's efforts to comply. If in the case of (CSR), related activities vary massively between businesses and sectors and there is a lack of comparable indicators available, in the case of (ESG) activity, it is considered that they are easier to quantify and define. ESG policies are driven by strict criteria and require them to be embedded at the core of a business's strategy, rather than marginalized. The strength of (ESG) is that its requirements must be integrated into the company's business model and that its momentum is driven by asset managers, consumers, and employees demanding transparent business, and business practices oriented towards a purpose that aligns with business priorities.Furthermore, given today's changes in strategic management, all organizational strategic initiatives must be considered so that they work toward the same goals of improving the entity's organizational performance.

Starting from the fact that many American companies listed on the American stock exchange have adopted this ESG strategy, I chose as a subject the qualitative research of ESGs, namely the impact that (ESG) scores have on the financial performance of the following 23 American companies: *Microsoft (MSFT)*, *Linde (LIN), Accenture (ACN)*, *J.B. Hunt (JBHT)*, *Xylem (XYL)*, *Texas Instruments (TXN)*, *Salesforce. Com (CRM)*, *Metropolitan Bank (MCB)*, *Nvidia (NVDA)*, *Oracle (ORCL)*, *Motorola Solutions (MSI)*, *Crown Holdings (CCK)*, *Nike (NKE)*, *Qiagen (QGEN)*, *ASGN(ASGN)*, *Dover (DOV)*, *Lam Research (LRCX)*, *Apple (AAPL)*, *Owens Corning (OC)*, *Adobe (ADBE)*, *Mohawk Industries (MHK)*, *Goldman Sachs (GS)* and *Cadence Design Systems (CDNS)*.

In the future, since the subject is an interesting one, I want to analyze in other works the European market with the new regulations promoted by the European Banking Authority and especially the financial market in our country where it is recommended to emphasize the role of the previously mentioned ideas regarding environmental,

social, and corporate governance in a clear and practical way to apply banking institutions.

In their credit risk policies and procedures, banks should develop specific tests on environmentally sustainable credit policies and procedures covering the provision and monitoring of such credit facilities. This approach involves expanding the analysis tools with which the traditional bank operates, which are starting points for risk anticipation and performance simulation, modifying them while providing a dynamic picture of the bank's financial performance.

The analysis of the twenty American companies from various sectors of activity was carried out based on the research tools presented in the specialized literature, starting from the profitability indicators of the companies analyzed and calculated such as: EBITDA and ROE. Later I will show the degree of influence that the ESG score has on ROE and EBITDA, and in this way, the companies analyzed will be able to be compared and conclusions will be drawn related to how these regulations and (ESG) factors, lead to the financial performance of a company.

Literature review

The role of business in society has been discussed and expanded over the 50 years since Milton Friedman's landmark 1970 essay, "The social responsibility of business is to increase its profits" (Friedman, 2007), first published given in the New York Times and then re-published with other articles in the "Corporate Ethics and Corporate Governance" collection. Since then, and with exponential speed over the past two years, there has been a shift toward a broader understanding of how corporate decisions affect all stakeholder groups—not just shareholders. As a relatively new field that has found its way into academic topics, the relationship between corporate social responsibility and a firm's corporate financial performance is a phenomenon being explored in various research studies conducted around the world. These research studies (Cho et al, 2019) show a positive relationship between a firm's corporate social responsibility policies and corporate financial performance. To investigate this relationship, the researchers constructed a regression and preceded the analysis by providing several measures that they used to serve as proxies for key financial performance indicators (ie, return on assets serves as an indicator of profitability). Most of the studies that have been done on (ESG) for the banking sectors are recent, and in recent years (ESG) has increased its visibility due to how it can help predict the economic performance of a particular client (Klettner et al., 2013). The pressure to regulate (ESG) has become one of the most important factors in adopting regulations at the banking level. Since the universal and legal adoption of the Paris Agreement on climate change in December 2015, studies that attempt to focus on (ESG) performance (ESGP) and corporate financial performance (CFP) in the banking sector have begun to become commonplace in the scientific field. The Paris Agreement on Climate Change defined how financial market participants and business advisors should integrate (ESG) risks and opportunities into their processes to act in their client's best interests. A growing number of articles in the academic economic community have teams referring to banking business models that have begun to focus on environmental, social, and corporate governance issues as promising new paradigms for business management (Galbreath, 2016).

The strategy and the increasing interest of stakeholders in adopting socially responsible practices, together with the application of appropriate governance practices (Widyawati, 2019) have made the field of (ESG) regulation and the assessment of potential clients by their environmental, social, and corporate, governance practices an interesting field.

The inclusion of social objectives in internal processes can allow an increase in efficiency recoveries and the reduction of all costs, in addition, according to some articles (Serafim, 2020), banks' attention to (ESG) issues helps them reduce their cost of capital and expand their possible shareholder base due to the good publicity that is sometimes associated with compliance with ESG principles. Other studies that analyze the relationship between (ESGP) and corporate financial performance (CFP), such as those published after 2018 (Finger et al., 2018), this is because banks have certain unique characteristics compared to other legal entities. Specific circumstances, common only to banks, and the way processes are designed, lead to the exclusion of banking sectors from environmental, social, and governance performance studies that contain a multi-sector sample (Mirallas-Quirós et al., 2019).

Another article that seems to capture the relationship between financial performance and environmental, social, and governance actions in the case of banks is the one published by (La Torre et al., 2021).

Socially responsible investment (SRI) strategies that should be considered for the transition to sustainable development: the importance of integrating and communicating (ESG) parameters is the subject of the article written by (Sciarelli et al., 2021). The results obtained demonstrated that the companies studied for the article integrated (ESG) norms in (SRI) in a different way; thus, while some of them appear quite close to full integration, others have demonstrated less than total commitment to (ESG) norms.

More recent research has highlighted that investing in socially responsible funds can benefit from communicating the company's progress in implementing (ESG) regulatory outcomes (Renneboog et al., 2008). The previously mentioned factors have led several companies to increase their focus on screening the main criteria that are part of (ESG): transparency, ethics, impact, environment, society, and governance and the related allocation of assets and strategies that are considered by the company as possible future policies that must be taken as they appear (Przychodzen et al., 2016) In the specialized literature, there are numerous articles that deal with this problem using different methodologies, including the one written by Tarmuji et al (2016) in which the economic performances at the level nationally are correlated with the (ESG) score, concluding that they lead to economic growth for Singapore and Malaysia. An article that provides an example of calculating a score for (ESG) factors is the one written by Giannarakis et al (2014). In the specialized literature, an article that serves as an example of the approach related to the application and results of the questionnaires is the one written by Arli et al (2010) which shows that the public perception in emerging markets of a product of a company that complies with (ESG) rules, it is favorable only if the price and quality are the same as other products on the market.

Worth mentioning is the innovative works in the managerial field written by Stanescu Zbuchea and Panzaru (2020) which explores the relationship between transformational

leadership and innovative work behavior of employees, the study based on structured questionnaires: Multifactor Leadership Questionnaire, IWB, and psychological empowerment tool and shows a positive and significant relationship between them and Zbuchea, Ivan, and Mocanu (2021) which underlines the importance of the human dimension in the practice of sharing knowledge of non-profit organizations.

Methodology

The paper starts with the question "*In what way does the adoption of (ESG) requirements influence financial performance?*" through the methodology used I want to show the correlation between the adoption of regulations and requirements in the field of environmental and social governance and the financial and economic performance of companies.

The methodology used to calculate the influence of the adoption of environmental and social governance factors on financial performance indicators is carried out by using a sample of 23 American companies, namely: Microsoft (MSFT), Linde (LIN), Accenture (ACN), J.B. Hunt (JBHT), Xylem (XYL), Texas Instruments (TXN), Salesforce. Com (CRM), Metropolitan Bank (MCB), Nvidia (NVDA), Oracle (ORCL), Motorola Solutions (MSI), Crown Holdings (CCK), Nike (NKE), Qiagen (QGEN), ASGN(ASGN), Dover (DOV), Lam Research (LRCX), Apple (AAPL), Owens Corning (OC), Adobe (ADBE), Mohawk Industries (MHK), Goldman Sachs (GS) and Cadence Design Systems (CDNS), calculated and analyzed during the year 2021, aiming for other works to be noticed at the European level and especially in our country. In the present paper, an analysis at the company level will be attempted because, I believe that the effect of these regulations has as its main purpose the way in which companies carry out their activity, and at the same time, the direct effect of the requirements on the financial situation through performance indicators (ROE and EBITDA).

The main indicator for companies used in this paper EBITDA, represents the profit before the installation policy (interest), the fiscal policy (taxes), and the amortization policy (depreciation and amortization) and is a measure often used in measuring the profitability of a company. Some prefer EBITDA to net income because it can provide a more accurate representation of operating efficiency and is a good measure for comparisons with other companies. As a representative formula, EBITDA is calculated as follows:

$$EBITDA = \ Net\ Income\ +\ Taxes\ +\ Interest\ Expense \\ +\ Depreciation\ \&\ Amortization$$

ROE, the second indicator used in this paper, represents the return on equity and is characterized by the formula:

$$ROE = \frac{Net\ income}{Equity}$$

The return on capital is expressed in percentages, and the BAA condition for this indicator to be calculated is that the net income and equity have positive values. Investors suggest companies set as an objective a return on capital equal to or slightly higher than the average return on capital of other companies in the same sector of activity.

ROA, the third and last indicator on which I will perform the analysis, represents the profitability of the asset, and is characterized by the formula:

$$ROA = \frac{Net\ income}{Total\ assets}$$

Return on assets is an important indicator at the level of companies because it measures the efficiency of the capital allocated in fixed assets and in the current assets of the enterprise. Financial analysts recommend that this indicator register positive values as high as possible. To be able to see the level of efficiency of the company, the managers must also analyze other market factors such as: the inflation rate, the average rate of return on the activity sector, the interest rate on deposits, etc.

The way to see if a series is stationary or not is by performing the Augmented Dickey-Fuller test, which is characterized by the following formula:

$$\Delta y_t = \alpha + \beta t + \gamma y_{t-1} + \delta_1 \Delta y_{t-1} + \cdots + \delta_{p-1} \Delta y_{t-p+1} + \varepsilon_t$$

To be able to see if two or more variables influence each other, we test the Granger causality which is characterized by:

$$P[Y(t+1)\ \epsilon\ A \mid L(t)] \neq P[Y(t+1)\ \epsilon\ A \mid L_{-X}(t)]$$

where the hypotheses of the model are: H_0: the cause occurs before its effect and H_1: the cause has unique information about the future values of its effect.

Results and discussions

In carrying out this work, I chose to analyze 23 companies listed on the American stock exchange from different sectors of activity according to table 1:

Table 1. Illustration of the companies used (Source: Yahoo Finance)

Rank	Company	Symbol	Industry
1	Microsoft	MSFT	Computer Software-Desktop
2	Linde	LIN	Chemicals-Specialty
3	Accenture	ACN	Computer-Tech Services
4	J.B. Hunt	JBHT	Transportation-Trucking
5	Xylem	XYL	Machinery-Tools & Resources
6	Texas Instruments	TXN	Electronics-Semiconductor Mfg
7	Salesforce.com	CRM	Computer Software-Enterprise
8	Metropolitan Bank	MCB	Banks-Northeast
9	Nvidia	NVDA	Electronics-Semiconductor Fabless Mfg
10	Adobe	ADBE	Computer Software-Desktop
11	Oracle	ORCL	Computer Software-Database
12	Motorola Solutions	MSI	Telecom Services-Integrated
13	Crown Holdings	CCK	Containers/Packaging

14	Nike	NKE	Apparel-Shoes & Related Mfg
15	Qiagen	QGEN	Medical-Products
16	ASGN	ASGN	Commercial Services-Staffing
17	Dover	DOV	Machinery-General Industrial
18	Lam Research	LRCX	Electronics-Semiconductor Equipment
19	Apple	AAPL	Telecommunications-Consumer Products
20	Owens Corning	OC	Building-Construction Products/Misc.
21	Mohawk Industries	MHK	Building-Construction Products/Misc.
22	Goldman Sachs	GS	Banks-Money Center
23	Cadence Design Systems	CDNS	Computer Software-Design

The data in table 2 reflects the evolution of the companies for the year 2021, where we have performed a classification of the 23 companies in descending order according to the (ESG) score, the company rating, the superior sales growth rates, profit margins and return on equity (SMR rtg), return on capital ROE and EBITDA.

Table 2. Classification of companies (Source: Yahoo Finance)

Rank	Company	ESG Score	Comp Rtg	SMR Rtg	ROE	EBITDA (thousands)
1	Microsoft	76.3	99	A	47%	100,239,000
2	Linde	76	94	B	9%	9,512,000
3	Accenture	75.95	97	A	33%	10,956,029
4	J.B. Hunt	74.14	89	B	21%	1,870,713
5	Xylem	73.89	87	B	13%	791,000
6	Texas Instruments	73.14	88	A	58%	11,060,000
7	Salesforce.com	72.92	94	A	12%	3,782,000
8	Metropolitan Bank	72.68	96	A	12%	77,312.00
9	Nvidia	72.19	99	A	43%	9,357,000
10	Adobe	70.06	98	A	41%	6,917,000
11	Oracle	71.14	93	A	163%	13,292,000
12	Motorola Solutions	70.81	89	na	0%	2,113,000
13	Crown Holdings	68.66	89	A	41%	397,000
14	Nike	67.34	90	A	55%	7,515,000
15	Qiagen	66.73	92	A	19%	889,777
16	ASGN	66.73	90	B	17%	492,300
17	Dover	66.65	96	A	26%	1,804,759
18	Lam Research	66.47	90	A	71%	5,711,612
19	Apple	66.15	97	A	74%	131,698,000
20	Owens Corning	65.36	89	B	13%	2,172,000

21	Mohawk Industries	63.59	91	B	8%	1,876,033
22	Goldman Sachs	62.93	93	A	13%	16,179,000
23	Cadence Design Systems	62.69	95	A	34%	1,112,969

According to public information, in 2022 the companies with the highest ESG are: Nvidia from the semiconductor industry; Microsoft from the software and infrastructure industry; Software Industry Cadence; Lam Research from the semiconductor equipment and materials industry and Adobe from the software and infrastructure industry.
After grouping the companies according to the activity sector, I averaged the ESG scores according to the industries in which the companies collected by me operate and I could observe that the highest ESG score for the year 2021 was at the level of the Computer Software-Desktop sector (*71.51*) closely followed by the transport sector (*71.40*) and then by the medical and specialty chemicals sector (*71.36*).

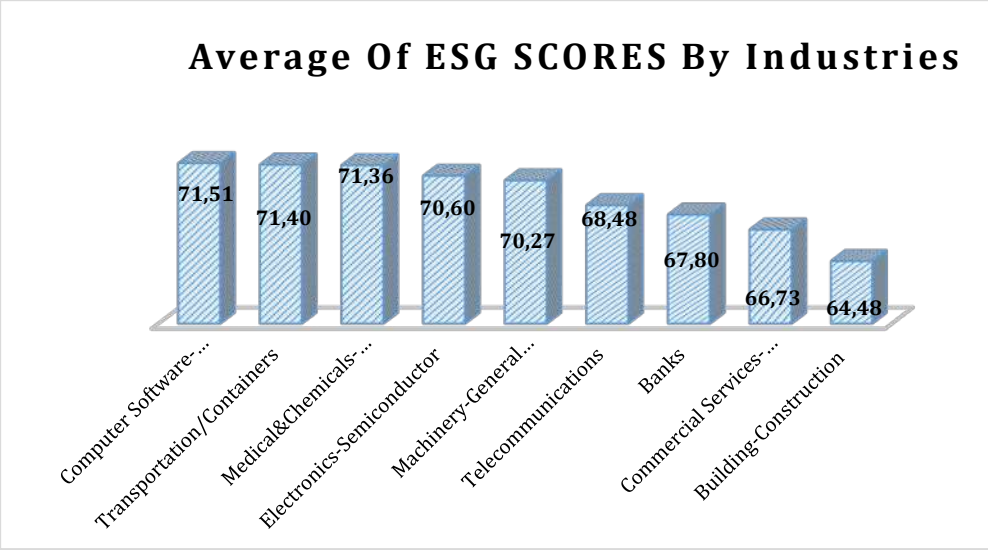

Figure 1. Classification of companies according to the sector of activity for the year 2021

From figure 2 we can see that from the point of view of the return on equity indicator, the sector with the highest percentage is the Electronics-Semiconductor sector (*57.3%*), closely followed by the Computer Software-Desktop sector (*55%*). What we can conclude is that the ESG score related to the Electronics-Semiconductor industry recorded a high value of (*70.60*), therefore there is a direct relationship between the ESG score and ROE.

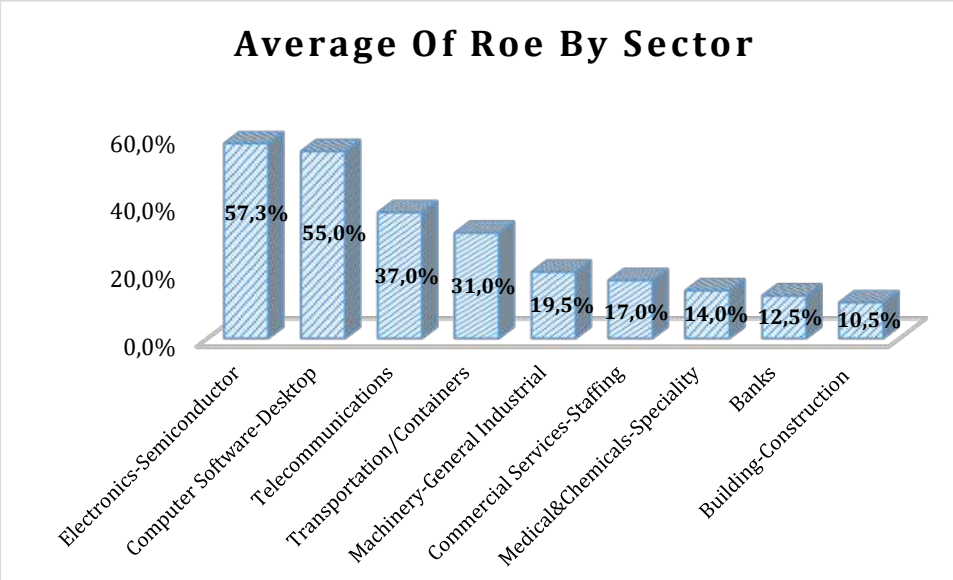

Figure 2. Average of ROE by each industry

To be able to answer the question "*In what way does the adoption of E.S.G. requirements influence financial performance?*" the collected data will be entered into the panel and then with the help of the EViews software we will check with the help of Granger causality if there is an influence in the data.
First, we test the data series to be stationary and then we will test if there is a causal relationship between the ESG score and EBITDA, and the results will be tested for lags 2-6. To observe whether or not the series is stationary, we will use the well-known Augmented Dickey-Fuller stationarity test on the 3 variables used in this work: ESG score, EBITDA, and ROE.
The results in the table below show that the data series are stationary, registering probabilities lower than 0.05.

Table 3. ADF test (Source:Own representation EViews10)

NULL HYPOTHESIS: ESG_SCORE HAS A UNIT ROOT		T-STATISTIC	PROB.*
AUGMENTED DICKEY-FULLER TEST STATISTIC		-4.867272	0.0009
TEST CRITICAL VALUES:	1% level	-3.769597	
	5% level	-3.004861	
	10% level	-2.642242	
NULL HYPOTHESIS: EBITDA HAS A UNIT ROOT			
AUGMENTED DICKEY-FULLER TEST STATISTIC		-5.798559	0.0001
TEST CRITICAL VALUES:	1% level	-3.788030	
	5% level	-3.012363	
	10% level	-2.646119	
NULL HYPOTHESIS: ROE HAS A UNIT ROOT		-4.989025	0.0006
AUGMENTED DICKEY-FULLER TEST STATISTIC	1% level	-3.769597	
TEST CRITICAL VALUES:	5% level	-3.004861	
	10% level	-2.642242	

As can be seen, there is no causal relationship between EBITDA and the ESG score. There would have been a possible influence from EBITDA to the ESG score if the probability from lag 4 and lag 6 had not exceeded the threshold of 0.05.

Table 4. Granger Causality Test EBITDA-ESG
(Source: Own representation EViews10)

PAIRWISE GRANGER CAUSALITY TESTS		F-STATISTIC	PROB.
LAGS: 2	EBITDA does not Granger Cause ESG_SCORE	1.95191	0.1744
	ESG_SCORE does not Granger Cause EBITDA	0.38595	0.6860
LAGS: 3	EBITDA does not Granger Cause ESG_SCORE	1.08411	0.3903
	ESG_SCORE does not Granger Cause EBITDA	0.30702	0.8199
LAGS: 4	EBITDA does not Granger Cause ESG_SCORE	2.76412	0.0876
	ESG_SCORE does not Granger Cause EBITDA	0.58923	0.6781
LAGS: 5	EBITDA does not Granger Cause ESG_SCORE	3.04126	0.0897
	ESG_SCORE does not Granger Cause EBITDA	2.76783	0.1085
LAGS: 6	EBITDA does not Granger Cause ESG_SCORE	2.48940	0.1983
	ESG_SCORE does not Granger Cause EBITDA	1.60333	0.3372

Table 5. Granger Causality Test ROE-ESG
(Source: Own representation EViews10)

PAIRWISE GRANGER CAUSALITY TESTS		F-STATISTIC	PROB.
LAGS: 2	ROE does not Granger Cause ESG_SCORE	0.27326	0.7644
	ESG_SCORE does not Granger Cause ROE	1.25160	0.3126
LAGS: 3	ROE does not Granger Cause ESG_SCORE	1.56465	0.2454
	ESG_SCORE does not Granger Cause ROE	1.02686	0.4128
LAGS: 4	ROE does not Granger Cause ESG_SCORE	3.60883	**0.0454**
	ESG_SCORE does not Granger Cause ROE	1.05606	0.4267
LAGS: 5	ROE does not Granger Cause ESG_SCORE	14.6082	**0.0014**
	ESG_SCORE does not Granger Cause ROE	2.95921	0.0949
LAGS: 6	ROE does not Granger Cause ESG_SCORE	9.62904	**0.0230**
	ESG_SCORE does not Granger Cause ROE	1.80989	0.2945

According to the results obtained after the Granger causality test, it can be seen that starting from Lag 4 and up to Lag 6, the hypothesis that ROE does not influence the ESG score ("ROE does not Granger Cause ESG_SCORE") is rejected because the probabilities do not exceed the threshold of 0.05. Therefore, it can be concluded that the Granger causality test shows an influence from ROE to ESG scores and not vice versa.

From the results obtained, we can say that they are in accordance with expectations because we can see that from a certain Lag, there is a causal relationship between ROE to ESG scores, which once again denotes that between the two variables, there is a relationship of positive and direct influence as we could see right from figure 2. Therefore, the answer to the question from which we started in this paper, namely "*In what way does the adoption of ESG requirements influence financial performance?*" is that

indeed the adoption of these requirements is beneficial to companies, especially when the ROE has a high percentage and the ESG score is high, fact demonstrated by the Granger Causality test.

Conclusions

From a theoretical and applied point of view, the paper addresses a new topic and leads to a more accurate understanding of the correlation between financial indicators and ESG performance in the banking system and companies

The article contributes to the literature in the field by further researching ESGs, but also by observing the fact that the number of companies that adopt ESG norms have an increase in their financial position, a fact that makes them a better potential client for financial institutions (banks in particular), as well as for their partners.

It also offers a new perspective to approach how environmental, social, and corporate governance factors influence the creditworthiness of a potential client or business partner.

The correlation between certain company indicators and ESG performance in the banking system leads me to study and analyze them in the future in Romania as well.

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