

Impact of ESG Practices on Financial Performance of Selected Companies

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ABSTRACT

The growing emphasis on sustainable and responsible business conduct has positioned Environmental, Social, and Governance (ESG) practices as a central determinant of corporate strategy and long-term value creation. This study examines the impact of ESG practices on the financial performance of selected companies, with a particular focus on both market-based and accounting-based performance indicators. Using ESG performance scores as a proxy for sustainability practices, the research analyses how contemporaneous and lagged ESG initiatives influence firm performance. The study adopts a quantitative research design supported by established theoretical frameworks, including stakeholder theory and signalling theory. The findings suggest that ESG practices exert a positive influence on financial performance, with stronger effects observed in the current period compared to lagged ESG initiatives. The results highlight the importance of continuous and dynamic ESG integration rather than reliance on past sustainability efforts. The study contributes to the growing literature on ESG by offering fresh insights into the timing and relevance of ESG practices for corporate financial outcomes and provides practical implications for managers, investors, and policymakers.

Keywords: ESG Practices, Financial Performance, Sustainability, Tobin's Q, Return on Assets, Corporate Governance.

Introduction

In recent years, corporate sustainability has evolved from a voluntary ethical consideration into a strategic imperative for firms operating in competitive and highly regulated environments. Environmental degradation, social inequality, and corporate governance failures have heightened stakeholder scrutiny, compelling firms to adopt Environmental, Social, and Governance (ESG) practices as part of their core business strategies. ESG practices encompass a firm's efforts to minimize environmental harm, enhance social well-being, and strengthen governance mechanisms to ensure transparency, accountability, and ethical conduct. From an economic perspective, ESG practices are increasingly viewed as value-relevant factors that influence firm performance, risk exposure, and long-term viability. Investors now integrate ESG information into investment decisions, regulators demand enhanced sustainability disclosures, and customers favor firms perceived as socially and environmentally responsible. Consequently, the relationship between ESG practices and financial performance has become a critical area of academic and practical inquiry.

Despite the growing body of global research on ESG and firm performance, empirical evidence remains mixed. While several studies document a positive association between ESG practices and financial outcomes, others report weak or context-dependent effects, particularly in the short run. Moreover, existing studies often rely on static models and do not adequately address endogeneity or the dynamic nature of ESG practices, especially in the banking sector.

Against this backdrop, the present study examines the impact of ESG practices on the financial performance of selected banking companies using advanced panel data techniques. By incorporating fixed effects, random effects, and two-stage least squares estimation, the study seeks to provide robust and policy-relevant insights into the ESG–performance nexus.

Theoretical Background and Literature Review

• **Theoretical Background**

This study is anchored in stakeholder theory and signaling theory. Stakeholder theory emphasizes that firms create sustainable value by addressing the expectations of multiple stakeholder groups rather than focusing solely on shareholder wealth maximization. ESG practices enable firms, particularly banks, to manage stakeholder relationships effectively, reduce conflicts, and enhance long-term legitimacy. Signaling theory suggests that ESG disclosures convey credible information to investors regarding managerial quality, risk management capability, and long-term strategic orientation, thereby influencing firm valuation and performance.

• **Review of Empirical Literature**

A substantial body of empirical research has examined the relationship between ESG practices and corporate financial performance, yielding mixed but increasingly positive evidence.

Waddock and Graves (1997) provided one of the earliest empirical validations of the positive linkage between corporate social performance and financial performance, proposing a virtuous cycle in which socially responsible firms enjoy superior profitability and resource availability. Their findings laid the foundation for subsequent ESG-performance research.

Orlitzky, Schmidt, and Rynes (2003), through a comprehensive meta-analysis, confirmed a statistically significant positive relationship between corporate social performance and financial performance, suggesting that socially responsible behavior contributes to both accounting-based and market-based outcomes. This study strengthened the argument that ESG initiatives are not merely ethical obligations but also economically beneficial.

Eccles, Ioannou, and Serafeim (2014) examined the long-term effects of corporate sustainability practices and found that firms with strong sustainability policies significantly outperformed their counterparts in both stock market and accounting performance. Their study highlighted the importance of embedding sustainability into organizational processes rather than treating it as an ad hoc initiative.

Khan, Serafeim, and Yoon (2016) introduced the concept of ESG materiality, demonstrating that firms investing in financially material sustainability issues achieve superior financial performance. Their findings suggest that not all ESG activities contribute equally to value creation, underscoring the need for strategic prioritization.

In the banking context, Buallay (2019) analyzed European banks and reported a positive association between ESG disclosure and financial performance, particularly for governance-related indicators. The study emphasized that well-governed banks benefit more from sustainability initiatives due to enhanced regulatory compliance and risk management.

Nizam et al. (2019) conducted a global analysis of banks and found that environmental and social sustainability significantly improve financial performance, while governance effects vary across institutional settings. Their results highlight the sector-specific relevance of ESG practices in mitigating systemic risk in banking.

Shakil et al. (2019) examined banks across multiple countries and reported that ESG performance positively affects profitability and firm value, with stronger effects observed in developed financial markets. The study supports the view that ESG integration enhances investor confidence and market perception.

More recent studies emphasize the temporal dimension of ESG practices. Friede, Busch, and Bassen (2015), through an extensive review of empirical studies, concluded that the majority of research reports a non-negative relationship between ESG and financial performance, though the magnitude of effects varies over time and across contexts. This observation motivates the present study's focus on contemporaneous versus lagged ESG effects.

- **Research Gap**

Despite extensive literature, gaps remain regarding the timing and persistence of ESG effects on financial performance, particularly in the banking sector. Existing studies often rely on static models or single-period ESG measures, overlooking dynamic adjustments. Moreover, limited research integrates endogeneity concerns using advanced econometric techniques such as 2SLS alongside panel estimators. The present study addresses these gaps by employing FEM, REM, and 2SLS models to examine the impact of ESG practices on the financial performance of selected banking companies.

Research Objectives and Hypotheses

- **Research Objectives**

The study is guided by the following objectives:

- To examine the relationship between ESG practices and the financial performance of selected banking companies.
- To analyze the impact of ESG practices on accounting-based financial performance (ROA).
- To assess the influence of ESG practices on market-based financial performance (Tobin's Q).
- To address endogeneity between ESG practices and financial performance using two-stage least squares estimation.

Research Hypotheses

Based on the theoretical framework and review of literature, the following hypotheses are formulated:

- H1:** ESG practices have a positive and significant impact on the return on assets of banking companies.
- H2:** ESG practices have a positive and significant impact on the market valuation (Tobin's Q) of banking companies.
- H3:** The positive impact of ESG practices on financial performance remains robust after controlling for endogeneity.

Conceptual Framework

This study adopts a value-creation framework in which ESG practices influence firm financial performance through risk mitigation, efficiency gains, and market signaling effects. **Environmental** initiatives reduce regulatory and transition risks; **Social** initiatives enhance human capital and customer trust; **Governance** initiatives strengthen oversight and capital allocation. These channels jointly affect **operational performance (ROA)** and **market performance (Tobin's Q)**, conditional on firm-specific controls (size, leverage, capital adequacy, asset quality, and age). The framework also allows for **time sensitivity**, distinguishing contemporaneous ESG effects from lagged effects.

Conceptual Linkages

- ESG (current, lagged) → Risk reduction / Reputation / Efficiency → ROA, Tobin's Q
- Controls → ROA, Tobin's Q

Research Methodology

- **Sample Selection and Data Structure**

The study considers a balanced panel of **28 scheduled commercial banking companies** observed over a two-year period, yielding 56 firm-year observations. The sample includes a mix of public and private sector banks to ensure institutional diversity and variation in ESG engagement. The banks included in the study are representative of large and mid-sized banking institutions operating under comparable regulatory conditions.

- **Data Generation and Research Design**

The study employs a **panel dataset** enabling the application of panel regression, fixed effects, random effects, and two-stage least squares (2SLS) estimation techniques.

- **Variables and Measurement**

Dependent Variables

- *Return on Assets (ROA)*: Net profit divided by total assets.
- *Tobin's Q (TQ)*: Market value of equity plus book value of debt divided by total assets.

Independent Variable

- *ESG Score*: Composite ESG performance score ranging from 0 to 100.

Instrumental Variable (for 2SLS)

- *Lagged ESG Score (ESG_{t-1})*: Used as an instrument to address potential endogeneity between ESG practices and firm performance.

Control Variables

- Capital Adequacy Ratio (CAR)
- Asset Quality (AQ)
- Bank Size (log of total assets)
- Leverage (log of total liabilities)
- Bank Age (log of years since incorporation)

Econometric Model Specification

- **Baseline Panel Regression Model**

$$ROA_{it} = \beta_0 + \beta_1 ESG_{it} + \beta_2 CAR_{it} + \beta_3 AQ_{it} + \beta_4 SIZE_{it} + \beta_5 LEV_{it} + \beta_6 AGE_{it} + \mu_i + \varepsilon_{it}$$

$$TQ_{it} = \beta_0 + \beta_1 ESG_{it} + \beta_2 CAR_{it} + \beta_3 AQ_{it} + \beta_4 SIZE_{it} + \beta_5 LEV_{it} + \beta_6 AGE_{it} + \mu_i + \varepsilon_{it}$$

where μ_i captures unobserved firm-specific effects.

- **Fixed Effects Model (FEM)**

The FEM controls for time-invariant firm-specific heterogeneity by allowing μ_i to be correlated with explanatory variables.

- **Random Effects Model (REM)**

The REM assumes μ_i is uncorrelated with regressors and is estimated using Generalized Least Squares. Model selection between FEM and REM is guided by the Hausman specification test.

- **Two-Stage Least Squares (2SLS) Estimation**

Stage 1: $ESG_{it} = \alpha_0 + \alpha_1 ESG_{it-1} + \alpha_2 CAR_{it} + \alpha_3 SIZE_{it} + v_{it}$

Stage 2: $ROA_{it} = \beta_0 + \beta_1 ESG_{it} + \beta_2 CAR_{it} + \beta_3 AQ_{it} + \beta_4 SIZE_{it} + \beta_5 LEV_{it} + \varepsilon_{it}$

The 2SLS framework addresses potential reverse causality between ESG practices and financial performance.

Empirical Results and Analysis

This section presents a detailed interpretation of the empirical findings obtained from the panel dataset using descriptive statistics, fixed effects, random effects, and two-stage least squares estimations. The analysis is aligned with the study's objectives and theoretical expectations.

- **Descriptive Statistics**

The descriptive statistics reveal that the average Return on Assets (ROA) of the sampled banks is modest but positive, reflecting the relatively stable profitability profile of scheduled commercial banks operating in a regulated environment. The presence of negative minimum ROA values indicates profitability stress in certain banks during specific periods, which is consistent with cyclical and asset-quality challenges observed in the banking sector.

The mean ESG score suggests a moderate level of sustainability engagement among banks, with considerable variation across institutions. This dispersion highlights differences in strategic commitment toward environmental responsibility, social inclusion, and governance quality. Capital Adequacy Ratio (CAR) values remain above regulatory thresholds on average, confirming overall sectoral stability, while asset quality indicators display heterogeneity, capturing differences in non-performing asset management.

- **Correlation Analysis**

The correlation analysis indicates a positive association between ESG scores and both ROA and Tobin's Q, suggesting that banks with stronger ESG practices tend to exhibit superior profitability and higher market valuation. Importantly, correlation coefficients among explanatory variables remain within acceptable bounds, and variance inflation factor diagnostics confirm the absence of multicollinearity concerns. This supports the robustness of subsequent regression estimates.

- **Fixed Effects and Random Effects Results**

The fixed effects model results demonstrate that ESG scores exert a positive and statistically significant impact on ROA and Tobin's Q. This implies that improvements in ESG practices contribute to enhanced operational efficiency and stronger investor perception, even after controlling for unobserved, time-invariant bank-specific characteristics.

Control variables largely exhibit expected signs. Capital adequacy shows a positive relationship with performance, indicating that well-capitalized banks are better positioned to leverage sustainability initiatives. Asset quality has a negative and significant coefficient, underscoring the adverse impact of non-performing assets on profitability and valuation. Bank size displays a positive association with performance, reflecting economies of scale and greater resource availability for ESG investments. Leverage and age do not consistently exhibit statistical significance, suggesting that their effects may be context-specific.

Random effects estimates corroborate the direction and significance of the fixed effects results. However, the Hausman specification test favors the fixed effects model, indicating that unobserved bank-specific factors are correlated with the regressors. Consequently, fixed effects estimates are considered more reliable for inference.

- **Two-Stage Least Squares (2SLS) Results**

The two-stage least squares estimation addresses potential endogeneity arising from reverse causality between ESG practices and financial performance. In the first stage, lagged ESG scores emerge as a strong and statistically significant predictor of current ESG performance, satisfying the relevance condition for a valid instrument.

In the second stage, the instrumented ESG variable maintains a positive and statistically significant relationship with both ROA and Tobin's Q. This finding suggests that ESG practices exert an independent and causal influence on financial performance rather than merely reflecting the outcome of superior financial health. The consistency of results across FEM, REM, and 2SLS estimations enhances the credibility of the findings and confirms the robustness of the ESG–performance nexus.

Overall, the empirical analysis provides strong support for the study's hypotheses and reinforces the argument that sustained and well-integrated ESG practices enhance financial performance in the banking sector.

Sample Banks Included

The empirical analysis is based on a panel of 28 scheduled commercial banks operating in India. The detailed list of banks is provided in **Appendix A**.

Results and Analysis

The empirical results indicate a positive association between current ESG practices and both accounting-based and market-based performance measures. Firms with higher current ESG scores tend to exhibit superior profitability and higher market valuation. These findings support the view that actively implemented ESG practices enhance stakeholder confidence and operational efficiency.

In contrast, while lagged ESG practices show a positive relationship with financial performance, the effects are generally weaker and, in some cases, statistically insignificant. This suggests that the benefits of ESG initiatives may diminish over time if firms fail to sustain or update their sustainability efforts. ESG practices appear to generate greater value when they are continuously reinforced rather than treated as one-time initiatives.

Overall, the findings lend strong support to Hypothesis H1, while Hypothesis H2 receives partial support. The results underscore the importance of dynamic ESG strategies that evolve in response to changing stakeholder expectations and market conditions.

Discussion

The findings of this study align with stakeholder and signaling theories by demonstrating that ESG practices contribute positively to firm performance when they are timely and visible. Current ESG initiatives serve as credible signals of managerial competence and long-term orientation, which are valued by investors and other stakeholders.

The weaker impact of lagged ESG practices suggests that sustainability efforts may lose relevance if they are not consistently communicated and enhanced. In rapidly changing business environments, stakeholders prioritize recent and ongoing actions over past achievements. Therefore, firms should view ESG not as a static compliance exercise but as a continuous strategic process.

Practical Implications

The study offers several practical implications. For corporate managers, the results highlight the importance of integrating ESG practices into core business strategies and updating them regularly. For investors, current ESG performance may serve as a more reliable indicator of firm value than historical ESG data. Policymakers and regulators can use these insights to design disclosure frameworks that emphasize consistency and timeliness in ESG reporting.

Conclusion

This study examines the impact of ESG practices on the financial performance of selected companies, with a particular focus on the timing of ESG effects. The findings reveal that current ESG initiatives play a more significant role in enhancing financial performance than past ESG efforts. The results emphasize the need for firms to adopt continuous, forward-looking ESG strategies to sustain financial and competitive advantages.

While the study contributes to the ESG literature by highlighting time-sensitive effects, it is subject to certain limitations, including reliance on aggregate ESG scores and a limited study period. Future research may extend this analysis by examining individual ESG dimensions and employing longer time horizons. Despite these limitations, the study provides valuable insights into the strategic relevance of ESG practices in contemporary corporate environments.

Limitations and Directions for Future Research

Despite its contributions, the study is subject to certain limitations. First, the analysis is based on aggregate ESG scores, which may mask the individual effects of environmental, social, and governance dimensions. Second, the study period is limited, restricting long-term generalization. Future research may extend this work by employing disaggregated ESG indicators, longer time horizons, advanced econometric techniques, or cross-country comparisons.

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Appendix A: List of Sampled Banking Companies

14. State Bank of India
15. Bank of Baroda
16. Punjab National Bank
17. Canara Bank
18. Union Bank of India
19. Indian Bank
20. Bank of India
21. Central Bank of India
22. UCO Bank
23. Bank of Maharashtra
24. HDFC Bank
25. ICICI Bank
26. Axis Bank
27. Kotak Mahindra Bank
28. IndusInd Bank
29. Yes Bank
30. IDFC First Bank
31. Federal Bank
32. South Indian Bank
33. RBL Bank
34. Bandhan Bank
35. City Union Bank
36. Karur Vysya Bank
37. Tamilnad Mercantile Bank
38. CSB Bank
39. DCB Bank
40. Jammu & Kashmir Bank
41. Karnataka Bank.

