

Analysis of the Impact of ESG Systems on Corporate Value

Ziyue Xu

School of Management, Guangdong University of Technology, Guangzhou, Guangdong, 510520
China

Abstract

Amid China's pursuit of its "dual carbon" objectives, Environmental, Social, and Governance (ESG) issues are garnering growing attention from an increasing number of corporations. The establishment of an ESG framework has emerged as a crucial vehicle for achieving sustainability goals. This article, through theoretical analysis, concludes that by embracing ESG systems, companies can enhance their financial performance, mitigate financing constraints, and diminish business risks, thereby augmenting their value. In order to promote the development of ESG systems, suggestions are also made to increase market awareness of ESG systems, establish a unified ESG evaluation system, and provide assistance for the coordination of market forces with government efforts.

Keywords

ESG; Corporate Value; "Dual Carbon".

1. Introduction

ESG (Environmental, Social Responsibility and Governance) is an investment concept and corporate evaluation standard that focuses on corporate environmental, social, and governance performance rather than financial performance. With the promotion of China's "dual-carbon" goals and gradual reform of the financial market, China is gradually establishing and strengthening regulatory requirements based on ESG disclosure. The "Action Plan to Improve the Quality of Listed Companies Controlled by Central Enterprises" issued by the State-owned Assets Supervision and Administration Commission of the State Council mentions actively participating in the construction of ESG disclosure rules, ESG performance rating, and ESG investment guidelines with Chinese characteristics, making greater contributions to the development of China's ESG system.

Compared with traditional corporate valuation and financial analysis methods, the ESG system pays more attention to non-financial research. The promotion of ESG system-related policies allows the public to evaluate the value of enterprises not only based on their economic benefits. ESG is the main driving force for promoting China's green transformation, the key to implementing low-carbon investment and financing, the basis for achieving "carbon neutrality," and the key to achieving sustainable development. Therefore, exploring the impact of the ESG system on corporate value is of great significance.

2. Literature Review

In 2004, the United Nations Environment Programme proposed ESG for financial action, which has received widespread attention internationally. Looking back at various countries, China's ESG system construction started relatively late compared to some countries. Although relevant departments and scholars have started paying attention, research compared to other countries is still relatively limited.

Gillan and Starks have found a strong correlation between ESG and corporate value[1]. Fatemi, Glaum, and Kaiser have found that good ESG performance can enhance corporate value, while

poor ESG performance can decrease corporate value[2]. Most scholars believe that the ESG system has a positive effect on enhancing corporate value. Research conducted by XUE, GUO, and XIAO et al. found that improving a corporation's ESG (Environmental, Social, and Governance) performance promotes an increase in its value; enhancing ESG performance can have a more positive impact on corporate value[3]. Wang and Yang used Chinese A-share listed companies from 2015 to 2019 as research samples and found that ESG performance has a significant positive impact on both the book value and market value of companies, thereby positively affecting the corporate's value[4]. However, a small number of scholars believe that the ESG system has a restraining effect on enhancing corporate value. Sasse examined European companies and believed that undertaking ESG responsibilities requires long-term investment and involves high risks, and that better ESG performance may actually reduce a corporate's performance[5]. There are also some scholars, such as Atan, who found that there is no significant relationship between corporate ESG performance and net asset return on investment and corporate value using Malaysian companies as samples[6].

3. ESG Practices in China

Currently, China's economic development is in a critical period of transformation from high-speed to high-quality development, and sustainable development has become a new direction for enterprise and even social transformation. Under the model of rapid economic development, enterprises mainly focus on their own economic benefits, and many external factors are overlooked. The ESG system pursues ecological environmental protection, harmonious social development, and optimization of corporate governance, which is highly consistent with the new development concept of China logically.

China has conducted some exploration and practice in the field of ESG (environment, society, and governance). At the policy level, China has established a series of systems closely related to ESG, such as green finance and carbon trading. ESG as a policy concept has gradually attracted the attention of regulatory authorities. However, in terms of regulation, China has not yet formed a systematic ESG information disclosure standard. At present, ESG disclosure is mainly based on voluntary principles, and guidance and training are conducted, while mandatory disclosure requirements are limited to environmental information.

Since 2009, the number of ESG reports released by A-share listed companies in China has been increasing, and the situation has even shown a breakthrough trend in 2022, with over 31% of A-share listed companies issuing ESG reports. Overall, listed companies pay increasing attention to the development of the ESG system, as shown in Figure 1.

Data from the study reveals that from 2009 to 2021, there has been a steady increase in the number of ESG reports, with the proportion remaining relatively stable. However, there was a breakthrough in 2022, with the proportion reaching 31.5%. Observing the ESG report release status of the constituents of the CSI 300 Index, leading companies have shown significant attention to the ESG framework. This trend indicates a continuous increase in the number of A-share listed companies in China that proactively disclose ESG-related information. With the promotion of the dual-carbon target and sustainable development, Chinese enterprises are also continuously enhancing their focus on the ESG framework. Overall, however, the total proportion of ESG reports released remains low, partly due to the extensive information required for disclosure, the existence of ESG risk events, and somewhat inadequate driving force for ESG disclosure.

As ESG continues to develop, mainstream ESG evaluation systems are gradually taking shape. Among them, the more authoritative international ones include MSCI, FTSE Russell, and Refinitiv, while China also has emerging rating agencies such as SynTao Green Finance and IIGF. However, there are some limitations to ESG rating systems. The exact definition of ESG is not

yet uniform across countries; different agencies and organizations have their own interpretations, and the credibility of some ratings is uneven. Although many institutions in China have released related reports on ESG business, they are relatively unknown and their market promotion is quite limited.

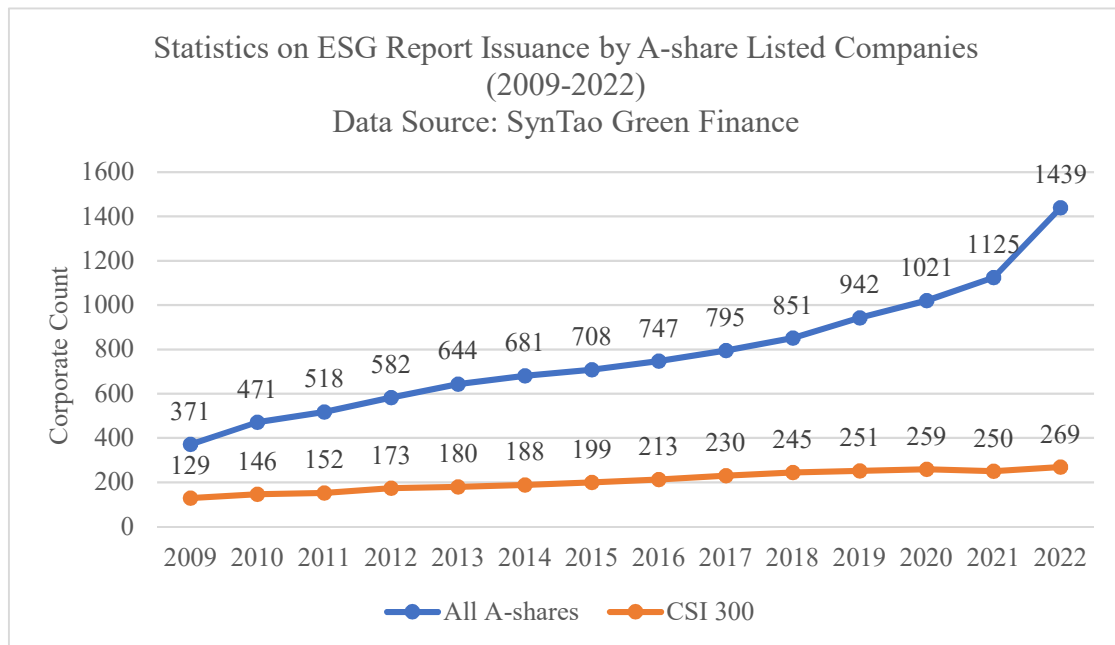


Figure 1. Statistics on ESG Report Issuance by A-share Listed Companies (2009-2022)

4. The Impact of ESG Systems on Corporate Value

4.1. ESG Systems and Financial Performance

ESG system requires businesses to focus on environmental, social, and corporate governance aspects. With regards to environmental aspects, companies committed to energy conservation, emission reduction, and environmental protection investments can build long-term stable partnerships with the government, thereby gaining more financial assistance and tax breaks. Additionally, these companies can analyze market strategies and tap into customer segments that value green consumption, expanding their potential customer base. As for social aspects, companies that effectively fulfill product safety responsibilities have a positive brand image, leading to favorable word-of-mouth and influencing customer loyalty, dependence, and market share, thereby enhancing financial performance. Furthermore, companies that adhere to labor standards and strictly enforce safety production systems can create a people-centered work environment for employees, contributing to increased production efficiency and innovation. In terms of governance, companies demonstrating strong ESG performance possess mature systems and mechanisms, fostering strong employee belonging and identity, promoting a positive corporate culture, and maintaining stable profitability and operational capabilities. Such companies actively disclosing ESG information can gain more financial performance benefits.

Stakeholder theory posits that businesses should not solely focus on shareholder interests but also consider the interests of all stakeholders. The ESG allows stakeholders to access more corporate information. From a consumer perspective, companies with strong ESG performance often gain higher recognition, which can potentially increase consumer purchases and frequency, thereby enhancing sales and operational performance. From the government's viewpoint, companies with strong ESG performance are more likely to benefit from favorable government policies and support measures. Additionally, when the government acts as a

consumer, it tends to prefer products from these companies, contributing to improved financial performance. Through the ESG system, companies can implement environmental protection measures, enhance social responsibility, and improve corporate governance frameworks and systems. These measures optimize the interaction between companies and stakeholders, benefiting stakeholders and enhancing the companies' competitiveness. This meets contemporary demands and thus gains market advantages, significantly improving financial performance. Conversely, companies with poor ESG performance may face negative public opinion and reduced brand value. At the same time, this may face stricter government penalties and regulations, and financial institutions may also restrict their financing channels, all of which may cause difficulties in cash flow and have a negative impact on the financial situation.

Therefore, improving a corporate's ESG performance can enhance its operational efficiency and profitability, which in turn boosts its financial performance and increases its corporate value.

4.2. ESG Systems and Financing Constraints

In reality, the financial market is not perfect, and there is asymmetric information between external investors and companies. Information asymmetry is one of the main reasons for financing constraints, which are considered to be a key problem hindering the development of small and medium-sized enterprises (SMEs). When companies improve their information transparency, they can attract the attention and participation of intermediary institutions. In-depth analysis and interpretation of corporate information by analysts can help investors gain a more comprehensive understanding of the corporate, thereby reducing the information gap between the demand for funds and the supply of funds, effectively alleviating the financing difficulties.

ESG serves as an information transmission function, showcasing many non-financial characteristics of companies to the outside world. By demonstrating good ESG performance through the ESG system, fund holders can gain a more direct and objective understanding of the information conveyed by the corporate. The ESG system also includes information on environmental governance, and good ESG performance can demonstrate to investors the corporate's environmental protection measures and high-quality growth, reducing concerns about environmental risks. At the same time, the demonstration of social responsibility enhances the corporate's reputation. This not only helps to gain support from the government and state-owned banks but also signals to other investors a commitment to actively fulfill their responsibilities, boosting their confidence and easing financing constraints.

According to stakeholder theory and signal transmission theory, companies, through improving the ESG system and utilizing good ESG performance, transmit signals of high-quality development to internal and external stakeholders, thereby alleviating the "adverse selection" phenomenon caused by information asymmetry, further increasing the trust of stakeholders, and using their influence to mitigate financing constraints. Good ESG performance helps companies to convey signals of their high-quality development to fund holders, obtain more information incrementally, and compensate for stakeholders' inadequate understanding of the corporate's development, thereby alleviating financing constraints.

Alleviating financing constraints can increase a corporate's cash flow, enhance its innovation capabilities, improve its ability to resist external risks, and further augment its enterprise value. Good corporate ESG performance provides investors with comprehensive financial and non-financial information, allowing them to better understand and evaluate companies. Based on this, the paper proposes that enterprises can reduce financing costs, alleviate financing restrictions, and enhance enterprise value by effectively utilizing the ESG framework.

4.3. ESG Systems and Corporate Risk

Enterprise risk refers to the potential impact of future uncertainties on a corporate's ability to achieve its business objectives. These risks are integral to the survival and development of the corporate and could lead to bankruptcy.

A corporate that demonstrates strong ESG performance typically indicates higher standards of risk management and compliance, which helps mitigate legal risks associated with conflicts of interest. By showcasing the impact on enterprise risk, good ESG performance enables stakeholders to gain a deeper and more comprehensive understanding of the corporate, thereby enhancing its overall value. Strong ESG performance can help companies build moral and reputational capital, providing a buffer against adverse external impacts. In times of a deteriorating external economic environment, companies may face challenges such as customer loss, financing difficulties, and declining stock prices. However, those with good ESG records often have a solid foundation of cooperation and trust with their stakeholders, making it more likely to garner support to overcome these difficulties. As legal systems related to ESG continue to be refined, companies that neglect aspects like employee rights, product quality, and environmental protection within the ESG framework face not only legal repercussions but also significant economic losses due to damaged reputations. The ESG framework includes non-financial dimensions such as environmental impact, social responsibility, and corporate governance in its analytical scope. When enterprises achieve better performance in these non-financial factors, their risks will be reduced, which is more conducive to the risk management of enterprises. To sum up, the better ESG performance, the less risk to the enterprise, which in turn increases the value of the enterprise.

5. Conclusion and Suggestion

The ESG system is closely related to the dual carbon targets and serves as a primary force in driving green transformation. The ESG system has sparked intense discussion; however, due to its recent emergence and an immature framework, society has yet to establish a unified and clear understanding of it. Through theoretical analysis, this article draws the following conclusions: Companies can enhance their operational efficiency and profitability through the ESG system, improve their financial performance, alleviate financing constraints, and reduce corporate risks, thereby enhancing corporate value.

For companies, the ESG system is an important pathway to bolstering their own sustainable development capabilities. Companies serve both as creators and beneficiaries of the value generated by the ESG system. To better harness the value of the ESG system, several suggestions are proposed:

First, enhance the market's understanding of the ESG system. Mature concept awareness is crucial for achieving collaborative efforts between companies and other social entities. Currently, China has not yet established a robust ESG integration mechanism, and a significant proportion of market entities still lack an understanding of the ESG system. In the process of creating corporate value, many issues are jointly determined by multiple market entities. Therefore, improving the market's level of awareness is fundamental for the ESG system to positively impact corporate value. Simultaneously, with the advent of the internet age and the continuous enhancement of consumer awareness of the ESG system, leveraging media to promote consumer understanding of the ESG system and tapping into its potential market has gradually become a new driving force behind the practice of the ESG system.

Second, establish a unified ESG evaluation system. As an increasing number of companies focus on ESG against the backdrop of dual carbon targets, the ESG evaluation system remains in its infancy, and the diverse ESG evaluation system frameworks emerging in the market, coupled with decision-makers' selective disclosure of ESG information, a unified ESG evaluation system

framework has not yet been established. To effectively implement the ESG concept, it is essential to refine the ESG evaluation system, accelerate the development of ESG information disclosure frameworks that align with international progress and are applicable to China's specific conditions, promote the maturity of the ESG evaluation system, provide visual data for ESG information users, and assist companies in enhancing their corporate value.

Third, coordinate market forces with government forces. Under the backdrop of promoting sustainable development, the value of the ESG system is co-created and shared by the market, relying on the optimization and progression of the capital market system. However, in the process of ESG development in China, some aspects are challenging to integrate naturally into the market. As market self-adjustment takes a long time and incurs high costs, government support becomes essential. In optimizing the ESG system, the government and the market collectively establish a dual framework to regulate corporate ESG practices, complementing one another. Through concerted efforts at both the institutional and capital operation levels, they foster an environment conducive for companies to implement and develop ESG.

Acknowledgments

Fund Project: 2023 Guangdong University Students Innovation Training Program "Research on the Impact Mechanism and Decision Pathway of ESG System on Enterprise Value under the Background of Two-carbon Target" (202311845047).

References

- [1] Gillan, S. L., Koch, A., & Starks, L. T. Firms and Social Responsibility: A Review of ESG and CSR Research in Corporate Finance[J]. *Journal of Corporate Finance*, 2021: 66.
- [2] Fatemi, A., Glaum, M., & Kaiser, S. ESG Performance and Firm Value: The Moderating Role of Disclosure[J]. *Global Finance Journal*, 2018, 38(2): 45-64.
- [3] Xue, T. H., Guo, Q., & Xiao, W. The Influence Mechanism and Empirical Study of ESG on Corporate Value under the Background of Dual Carbon Goals[J]. *Social Sciences Frontier*, 2022(11): 89-99+281.
- [4] Wang, B., & Yang, M. J. Research on the Impact Mechanism of ESG Performance on Corporate Value-Empirical Evidence from China's A-share Listed Companies[J]. *Soft Science*, 2022, 36(6): 78-84.
- [5] Sassen, R., Hinze, A. K., & Hardeck, I. Impact of ESG Factors on Firm Risk in Europe[J]. *Journal of Business Economics*, 2016, 86(8): 867-904.
- [6] Atan, R., Alam, M. M., Said, J., & Zamri, J. The Impacts of Environmental, Social, and Governance Factors on Firm Performance: Panel Study of Malaysian Companies[J]. *Management of Environmental Quality*, 2018, 29(2): 182-194.