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Title: Guest editorial: A short review of the role of ESG activities in business and research

Year: 2024

Version: Accepted manuscript

Please cite the original version:

Agapova, A. & Garanina, T. (2024). Guest editorial: A short review of the role of ESG activities in business and research. *Managerial Finance*, 50(1), 1-9. https://doi.org/10.1108/MF-01-2024-644

A short review of the role of ESG activities in business and research

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We thank Don Johnson, Chief Editor of Managerial Finance, for the opportunity to produce this special issue. We are grateful for his support throughout the project. We also thank the team at Emerald for their support. We are thankful for the response from authors across the academy for their interest in our project and for their valuable submissions, whether selected for this volume or not. Most importantly, we thank the anonymous reviewers who contributed so much of their valuable time and expertise, without compensation, to review the original submissions and to steer the manuscripts through the revision process.

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Involvement in environmental, social and governance (ESG) activities (also often called corporate social responsibility – CSR) has become important in making investment decisions in financial markets (Christensen et al., 2022). In line with the stakeholder and legitimacy theories, involvement in ESG practices may improve a company's value creation (Gregory et al., 2014), firms' financial performance (Li et al., 2018), quality of financial reporting (Garanina and Kim, 2023; Kim et al., 2012), disclosure policies (Agapova et al., 2023), lower cost of debt (Eliwa et al., 2021; Erragragui, 2018), improve firms' competitive advantage (Shrivastava, 1995; Russo and Fouts, 1997) and help establish long-term relationships with stakeholders (Donaldson and Preston, 1995).

Currently, ESG is moving from the periphery to the mainstream, transforming the capital and finance market (KPMG, 2022). Moreover, institutional investors more often reaffirm their desire to integrate corporate ESG performance into their investment decisions (Sood et al., 2023; Marshall et al., 2022). In 2021, fund investments in sustainable companies and investments of ESG-oriented funds increased globally by 53 per cent and reached US$2.7 trillion (KPMG, 2022). The Governance & Accountability Institute (G&AI) highlights high interest in ESG/CSR by reporting that 96% (81%) of companies listed in S&P 500 (Russell 1000) released sustainability or corporate responsibility reports compared with just under 20% in 2011 (G&AI, 2021). Nowadays, even "a successful IPO without taking ESG-specific requirements into account is difficult to imagine", says Jens Voss, partner, Deal advisory in KPMG. Analysis of ESG-related information has become an increasingly important part of the investment process (CFA, 2022). For investment professionals, a key motivation in considering ESG criteria as part of their financial analysis is to gain a fuller understanding of the companies they invest in (Amel-Zadeh and Serafeim, 2018).

Moreover, there is a large worldwide regulatory push to improve the identification, assessment, and disclosure of ESG-related information, including climate related risks. Numerous institutions, such as the Sustainability Accounting Standards Board, the Global Reporting Initiative, and the Task Force on Climate-related Financial Disclosures have been working to form standards and define materiality to facilitate incorporation of these factors into the investment process.

With this background, this special issue "ESG Practices, Disclosure and Investing Decisions" brings together insights on the links between corporate governance, ESG activities and financial performance of financial markets' participants.

The papers appearing in the special issue can be grouped into three main topics:

- Corporate governance and ESG activities
- ESG, financial markets and financial performance
- Literature review on sustainability-related topics

We provide a short summary of previous findings on the above-mentioned topics and then shortly describe the papers accepted to this special issue.

Corporate governance and ESG activities

Previous literature has analyzed the link between corporate governance characteristics and a firm's involvement in ESG activities. Evidence exists that women on board of directors and in leadership positions in general are associated with higher ESG/CSR scores (McGuinness et al., 2017; Borghesi et al., 2014). CEO age and confidence levels are other leadership characteristics that have been investigated in their relation to ESG outcomes. Borghesi et al. (2014) concludes that younger CEOs are more likely to lead companies that reflect better ESG scores. McCarthy et al. (2017) finds a negative relation between CEO confidence and a firm's involvement in ESG activities. The political background of top management team is another factor examined in its relation with ESG outcomes. For example, Di Giuli and Kostovetsky (2014) find positive links between political leanings of a top management team (captured with geographic clustering of political views of CEOs, directors and founders) and ESG performance indicators. However, Borghesi et al. (2014) find an insignificant relation between top management political views and ESG scores, using Di Giuli and Kostovetsky (2014)'s sample but during another time period, and call for further investigation of the relation. While most research papers investigate whether ESG/CSR performance is the outcome of well-governed managerial decisions (Gillan et al., 2021), some papers analyze the opposite relation and explore whether firms with superior ESG performance tend to adopt strong corporate governance initiatives (Kumar and Sujit, 2022). The papers appearing in this special issue try to address these inconsistencies in previous research and give a closer look on the link between corporate governance characteristics and a firm's involvement in ESG activities.

The four papers accepted to the special issue analyze the relation between corporate governance characteristics and ESG activities.

Lee et al. (2023) examine the link between ESG performance and top executive compensation in the U.S. financial services industry. The results reveal that an increase in ESG performance, and specifically social and governance performance indicators, are positively related to an increase in CEO compensation. The authors additionally analyze direct and indirect associations between ESG performance and top executive compensation contributing to the growing literature on the topic and ongoing debate related to inclusion of ESG KPIs in compensation system.

Ting and Lee (2023) analyze the impact of politically connected independent directors on sustainability disclosure in China. Regulation 18 introduced in China in October 2013 prohibited current government officials from holding positions in business entities and discouraged retired officials from exerting political influence on behalf of connected companies. By analyzing the consequences of this regulation, the authors find that companies with politically connected independent directors are characterized by an increase in sustainability disclosure after the introduction of Regulation 18. This effect is stronger for firms facing high political pressure or lacking alternative political power.

Khan et al. (2023) investigate the role of CSR committees in moderating the relation between CSR and firm performance. By analyzing 39 countries, the study provides international evidence that a CSR committee enhances the positive effect of a company's involvement in CSR activities on financial performance. Moreover, the benefits of CSR committee are even higher in countries with stronger governance and in environmentally less sensitive industries.

Brick and Qiao (2023) examine how CEO transitions impact CSR activities and firm value. The authors identify a tenure-varying pattern of CEO's influence on CSR. The authors observe that new CEOs often change CSR policies. Further, the empirical results reflect that a firm value increases (decreases) when the new CEO increases (decreases) CSR investments above (below) the industry average.

ESG, financial markets and financial performance

The second focus area of the papers published in this special issue is related to the role of ESG in decision making in financial markets. One of the United Nations Principles for Responsible Investment (UNPRI) states that "we will incorporate ESG issues into investment analysis and decision making" (UNPRI, 2006). Therefore, the launch of UNPRI highlights the importance that firms' ESG activities started to play in investment decision making that were mainly neglected before (Campbell and Slack, 2011). After joining the Sustainable Stock Exchange Initiative, 26 stock exchanges out of 106 have made ESG disclosure mandatory for listed companies and 60 exchanges have introduced guidelines related to ESG disclosure (SSEi, 2021). The importance of the ESG concept in financial markets is also a powerful tool for implementation of the "carbon neutral" goal. For example, China plans to achieve carbon neutrality by 2060, while European Union, Canada, South Africa, Japan and South Korea and a number of other countries will try to integrate the law of carbon neutrality by 2050 (Chen et al., 2023). That is another reason why companies as well as investment institutions have started paying so much attention to ESG aspects in their decision making (Chen et al., 2023).

Recently, some studies have also focused on the link between involvement in ESG activities and financial performance indicators, without reaching consensus on the subject. While some studies observe a positive relation between ESG and financial performance indicators (e.g. Bhattacharyya and Khan, 2023; Bose et al., 2017; Jahmane and Gaies, 2020; Miller et al., 2020), others find a negative association between the variables or no significant relation (Hasan et al., 2022; Lee et al., 2009; Price and Sun, 2017; Soana, 2011). To reconcile the observed inconsistencies, Friede et al. (2015) analyze about 2,000 papers published since 1970s, and conclude that 90% of studies find a nonnegative relation between ESG and firm performance indicators that is stable over time. Therefore, Friede et al. (2015) call for a better understanding of how to integrate ESG criteria into investment processes in order to harvest the full potential of value-enhancing ESG factors.

Some of the papers in the special issue add to the stream of the research on the effects of ESG activities on different performance outcomes. For example, despite the growing importance of ESG aspects in the M&A process, little empirical evidence exists on the role of ESG in post-merger success (Bereskin et al., 2018). Bereskin et al. (2018) emphasize importance of taking into consideration involvement of buyers and target companies in ESG activities during the M&A process. A paper in this special issue extends research on the topic. Moreover, some papers in the special issue also focus on developing countries that were overlooked by previous studies.

Another sub-area in the focus of this special issue is the green bond market that has been growing rapidly worldwide since its debut in 2007 and the effect of ESG activities on the financial outcomes of mutual funds or other managed portfolios. Green bonds are newly developed financial instruments with the specific goals of improving environmental impacts and social welfare (Tang and Zhang, 2020). A deeper analysis of the long-run effect of issuing green bonds adds value to previous research on the topic. Several papers find a positive relation between involvement of mutual funds in ESG activities and their investment outcomes. For example, Abate et al. (2021) find that funds that invest in ESG-related securities and have higher ESG ratings are characterized by better performance and lower ongoing charges. However, there is no evidence of significant differences in financial outcomes related to active or passive selection of high- versus low-ESG related stocks (Auer and Schuhmacher, 2016). This special issue also contributes to this stream of literature. To sum up, a second group of articles in this special issue tackles the topic of the link between ESG, financial markets and financial performance. Insights from these papers shed further light on the ESG determinants for long-term positive performance impacts.

Five papers accepted to the special issue explore the relation of ESG-related information and performance indicators. Baldi and Lambertides (2023) investigate how investments in companies involved in ESG impact performance of infrastructure funds. The authors conclude that strong social orientation and practices positively affect fund performance, governance-related investment policies do not significantly influence fund performance, and environmental investment policies are associated with lower performance results. The authors propose a few practical implications for fund managers that may improve performance indicators of infrastructure funds.

Swinkels and Markwat (2023) focus on disclosure of ESG-related information and compare carbon emissions data from different providers for equity and bond markets. Even though previous researchers claim about a high level of confusion regarding ESG scores (Christensen et al., 2022; Kimborough et al., 2022), the authors reveal that there is less confusion regarding direct and indirect carbon emissions. However, higher dispersion among data providers is observed while revealing information about carbon emissions not by single companies but along the supply chain. As corporate disclosures now play an important role in decision making in financial markets, the authors offer some suggestions on how to improve the coverage of information related to carbon emission data.

Makpotche et al. (2023) examine the long-run effect of corporate green bond issuance for issuer firms: the long-run stock market performance and the long-run environmental performance. The authors document that, in the long-run, green bond issuers improve financial and environmental performance of their firms, especially for multiple-times issuers and issuers operating in industries where the natural environment is financially material.

Rahman and Wu (2023) explores the relation between companies' involvement in ESG activities on merger and acquisition (M&A) outcomes in China. Following the results of empirical analysis, the authors conclude that acquiring targets with high ESG performance leads to the increase of bidders' ESG performance. The authors emphasize that involvement in M&A deals with ESG-active targets may improve performance indicators of acquiring companies in an emerging Chinese market.

Datar et al. (2023) examine the relation between ESG focus of Special Purpose Acquisition Companies (SPACs) and their performance. Unlike a traditional initial public offering (IPO) where the issuer has existing business operations, in a SPAC IPO the SPAC is a blank-check company without any business operations that is formed by sponsors, who raise capital in a public offering with the goal of subsequently merging with a private company. The study reveals that ESG-focused SPACs tend to have higher market capitalizations but worse post-merger operating performance. The authors conclude that investing in post-merger SPAC firms is a poor investment in general, but investing in SPACs that acquire ESG-oriented businesses would generate an additional average loss in a post-merger period.

Literature review on sustainability-related topics

Finally, two papers included in the special issue provide literature reviews on the topic of sustainability.

Ali and Wilson (2023) present a systematic literature review of 159 empirical studies to define the factors influencing sustainability disclosure. The authors identify macro-level (e.g., legal, political), meso-level (e.g., industry, media), and micro-level (e.g., governance, executive attitudes) factors influencing sustainability disclosure in developed and developing markets. The conclusions reveal that the country context is an important factor that drives sustainability disclosure. Therefore, companies in developing markets feel minimal public pressure for sustainability disclosure and are rather influenced by international NGOs, the media, international buyers to improve sustainability disclosure that is opposite to the findings from developed countries.

Singhania et al. (2023) provide a comprehensive review of literature on sustainable investments that represent a class of investments combining financial returns with mitigating environmental challenges, achieving sustainable development goals, and creating a positive business impact. By applying several bibliometric techniques enhanced by content analysis, the authors identify the key researchers, journals, and emerging research themes within sustainable investment corpus of literature. The literature review identifies the following hot topics in research that emerged since 2020: sustainable development goals and financing via green bonds; investor impact creation via shareholder engagement and field building strategies; and governance-related determinants of firm-level sustainable investments. In conclusion, the authors discuss the research gaps across these themes and identify future research questions.

The papers included in the Special issue lead us to the following future directions on ESG research. Future research may focus on further analysis of ESG-related activities in infrastructure funds and identify the role of various sub-facets of ESG activities, such as green investments for eco-innovation, technological development or greenwashing that can be important factors influencing fund performance indicators (Baldi and Lambertides, 2023; Swinkels and Markwat, 2023). As ESG disclosure starts to play an important role in decision making, clearer guidelines and regulations are needed to make information more reliable and comparable. One of the research directions is related to analysis of carbon intensity of companies while constructing portfolios (Swinkels and Markwat, 2023). Rahman and Wu (2023) call for further investigation of the role of ESG performance and disclosure (and separate pillars) in M&A deals, as it has been observed that involvement in ESG activities significantly effects the relation between ESG strategy and corporate performance in the context of M&A activities. Lee et al. (2023) call for further analysis of the effect of different economic conditions on the relation between involvement in ESG activities and executive compensation scheme. Future research can also investigate whether explicit ESG incentives for CEOs serve to increase their own compensation or serve stakeholders' interests.

Ting and Lee (2023) suggest several avenues for exploration. First, as the authors point out the importance of country context, examining the effectiveness and impact of regulatory interventions on sustainability disclosure in different countries would provide valuable insights. Second, future studies can explore the mechanisms through which political connections influence sustainability disclosure practices that might deepen the underlying dynamics and processes. Finally, investigating the effect of different stakeholders on sustainability disclosures could provide a more holistic perspective on the research topic.

Khan et al. (2023) call for analysis of the role of CSR committees across different countries with respect to their level of market development, economic growth, and cultural values. Further, as scholars have investigated the positive role of CSR in safeguarding firm value during the pandemic, the authors call for papers that will focus on analyzing the relation between CSR committees and firm value during Covid-19 period. Finally, future studies can focus on different characteristics of a CSR committees that might influence firm performance indicators.

Based on the results of the literature review, Ali and Wilson (2023) encourage future studies to analyze the topic of sustainable investments through meta-analysis. The authors report many inconsistencies in empirical findings that might arise due to factors such as culture and country context. Therefore, these conditions need to be examined as moderators in conducting future empirical research. Moreover, the authors call for theoretical advances in the field of sustainability.

Singhania et al. (2023) confirm previous results about the difficulties in evaluating ESG disclosure and sustainable investments. They suggest applying technological innovations such as artificial intelligence (AI) and natural language processing (NLP) for analyzing ESG-related information to better standardize the outcomes for efficient decision making.

To sum up, the papers accepted to this special issue shed light and provide ideas for future research directions in relation to ESG practices and disclosure for decision making. The results of the papers highlight the importance of incorporating sustainability aspects into operations of companies and financial institutions, so investors, consumers, policy makers, and other stakeholders could better absorb ESG-related information in decision making.

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