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## The Impact of ESG Disclosures on Financial Performance: Evidence from European Listed Companies

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## ABSTRACT

The increasing global emphasis on sustainability has prompted firms to integrate ESG practices into their strategic agendas. This study investigates the impact of ESG disclosures on firm financial performance, focusing on firms operating within the European manufacturing sector. Using a fixed-effect panel regression model, the analysis incorporates firm-specific control variables such as firm size, capital structure and capital asset intensity to ensure robustness. The empirical findings reveal a statistically significant and positive relationship between ESG engagement and firm profitability, supporting the notion that sustainable practices enhance organizational resilience and stakeholder trust. The results are interpreted through the lens of Stakeholder Theory, the RBV, and the Trade-Off Theory, highlighting how ESG activities serve as both strategic resources and mechanisms for managing stakeholder expectations.

**Keywords:** Environmental, Social, Governance, ESG, Sustainability.

### Introduction

In the contemporary global world sustainability is demanded in every field, especially in business domain. The focus of sustainable development is not just to attain long-term sustainability but also to retain and improve with the passage of time. In case of economic long-term sustainability is not possible without having durable financial system (Aras et al., 2018). Due to this enhanced global competition, companies operating across the globe are under huge pressure for making firms sustainable which is vital for both organizational resilience and broader economic advancement (Maji & Lohia, 2023). In the past, it is observed that firms orientation is normally short-term focused as they primarily prioritized recent future gains without considering their impact on the environment, society and governance (ESG) (Biju et al., 2025). However, in contemporary era, due to paradigm shift towards the sustainability, firms are taking keen interest in the ESG domain alongside their traditional profit-driven objectives (Tumewang et al., 2025). Alshehhi et al. (2018) stresses that for achieving competitiveness in the market firms need to be focused on the sustainable business practices by ecological and societal well-being. Yuan et al. (2022) confirmed the growing inclination of the global firms for considering ESG factors in their decision making. There is a significant increase in the numbers from 734 in 2010 to 3800 in 2020. United Nations (2015) also pointed the importance of sustainability for the every field of life by including 17 Sustainable Development Goals (SDGs) targeted for completion by 2030.

Furthermore, a rapid growth in international trade due to information and technological development further increases the importance of ESG activities in the globe. While ignoring these aspects has a devastating impact on the firm leading to reduce its survival probabilities (Malik & Kashiramka, 2024). In 2001, Global Reporting Initiative (GRI) was launched which guide the firms to

develop their strategies and long-term goals considering sustainability specially ESG measures (Sharma et al., 2020). Broadstock et al. (2021) supported that stance that firms involved in ESG activities and disclosure builds trust among investors and all other stakeholders in volatile markets by improving the clarity and quality of non-financial disclosure. Investors and other stakeholders increasingly recognize the importance of ESG in the business domain as they allocate 3.9 trillion US dollars to sustainable assets by 2021 (Li & Rasiah, 2024). Stakeholders increasingly demand the ESG disclosures, leading to transparency in business operations. This rising trend underlines their focus on ESG as a critical driver of long-term firm performance (Haarstad, 2020).

Engagement in ESG activities has gained significant attention globally, European firms also realized its importance. Firms operated in the European region which is the blend of developed and emerging economies needs to maintain a proper balance between their revenue generation and ESG activities (Liang et al., 2024). ESG activities help the firms to toward improved efficiency of asset utilization, low-cost availability of capital leading to improve market position in the competition (Burki et al., 2024). The main reason behind this is customers and investors trust, improved transparency and risk management, (Asif et al., 2023), operational excellence (Khanchel & Lassoued, 2022). Firms ESG engagement help the firm to improve its reputation by winning the confidence of the stakeholders leading to long-term sustainable value creation (Adam et al., 2025).

However, Paridhi et al. (2024), Miralles-Quirós et al. (2019) and others argued that engagement in ESG activities is not always a token of success for the firm in any case. It is because engagement in these activities has associated positively related costs. Firms always have limited availability of funds and diverting them to ESG focused activities compromised the core business revenue generating activities. These contradictory facts need to be clarified whether European manufacturing firms engaged in ESG activities improve their performance or not. This study aims to find out the answer to this research question to provide insight to the practitioners and policy makers for drafting future layout.

### **Theoretical foundation for ESG and Firm Performance**

The theoretical foundation for this study is drawn from Stakeholder theory, as proposed by Freeman (1984) which explains that firms should never just focused only on its shareholders but to on the interests of all stakeholders to achieve sustainable performance. It helps the firms to build trust among all the stakeholders most specially customers, owners, employees and supplier which may have been eroded by events such as financial crises. However, prior existing literature shows that a mix relationship exist between ESG and firm performance across the globe. This can be explained by the trade-off theory given by Kraus and Litzenberger (1973) which

explains that ESG engagement has associated costs with benefits. Up to certain level firm's engagement in ESG activities increases its performance as the benefits are greater than associated costs of activities. While the Resource-Based View (RBV) proposed by Barney (1991) explains that ESG activities give firm a competitive advantage over its counterparts which act as a trump card to improve sustainable firm performance.

### **ESG and Firm Profitability**

Maji and Lohia (2023) examined the firms operated in India and confirmed that ESG has a positive impact on their performance by enhancing profitability and market valuation. Buallay (2019) examined the European banks between 2007 and 2016 which confirmed that ESG improves overall performance of the banks however, the individual impact of environmental activities has improved the performance while social engagement reduces the firm profitability due to misuse of the funds by the management for personal gains. While it increases market valuation of the firm. Ademi and Klungseth (2022) studying the 150 US firms listed on S&P 500 between 2017 and 2020. The results confirmed that if the firms are actively engaging in ESG activities then it will have better financial performance as well as market value than those firms with no or weak ESG engagement. Miralles-Quirós et al. (2019) after studying 166 firms across various countries covering developed and developing countries confirmed that ESG has positive impact on firm performance. However, each of its factors has different impact on firm performance. Behl et al. (2022) studied Indian firms and confirmed that ESG and firm performance has no bidirectional causality. However, results further highlight that the impact of ESG activities takes time to be evident as initially it increases the associated costs while the benefits will be retrieved in the near future. Maroun (2015) performed a meta-analysis and synthesis that ESG activities reduce agency costs and bridge information gaps between management and stakeholders due to transparency which increases firm performance and market reputation. Tommaso and Thornton (2020) supported the above claimed by Maroun (2015) and confirmed that due to transparency overall misuse of the funds reduces leading to increase performance along with risk diversification by the firm's management. While Azmi et al. (2021) studied firms from the developing economies and confirmed that a U-shaped relationship exists between the ESG and firm performance. Results confirmed that high engagement led to diminished returns due to significant opportunity costs which is inclined with trade off theory. Similar results reported by El Khoury et al. (2023). While the study of Lamanda and Tamásné Vőneki (2024) claimed that no relationship exists between ESG and firm performance which is further criticized by the Liang et al. (2024) while examining Western banks and Biju et al. (2025) while studying banks from emerging economies and confirmed a positive relationship between ESG and firm performance.

**Hypothesis: ESG disclosures has no influence on the profitability of European firms.**

#### **Research Methodology**

The data for this study is collected for 150 listed manufacturing firms on STOXX Europe 600 index, covering the period from 2015 to 2023. Financial firms are not considered in this study as they have different accounting practices and sector specific regulatory frameworks and norms. Along with that only those firms which have remained active on STOXX are considered and have no missing data. The data related to the firms ESG, and financial performance is collected from Bloomberg and LSEG (London Stock Exchange Group - Workspace). Individual scores of environmental, social and governance is collected and a comprehensive index is developed based on Javaid and Raza (2025) methodology. Measuring the firm's performance return on asset (ROA) is considered as it covers the stakeholder's perspective not just shareholders perspective, like return on equity (ROE). Firm-specific control variables used in this study are firm size which is measured using natural log of firm total balance sheet assets and firm capital structure which is the ratio of firm total debt to total equity. Capital intensity of the firm is also measured using the ratio of net property plant and equipment to total assets.

**Table 1: Variable Definitions and Measurement**

Variable Category	Variable Name	Measurement	Source
Independent	ESG	Composite index (0-100%)	Javaid and Raza (2025)
Dependent	Return on Assets (ROA)	Net Income / Total Assets	Broadstock et al. (2021)
Firm-Specific Controls	Firm Size (FS)	ln(Total Assets)	Chen et al. (2025)
	Capital Structure (CS)	Total Debt / Total Equity	Malik and Kashiramka (2024)
	Capital Intensity (CA)	Net Property, Plant, and Equipment / Total Assets.	Chen et al. (2025)

$$ROA_{it} = \beta_0 + \beta_1 ESG_{it} + \beta_2 FS_{it} + \beta_3 LEV_{it} + \beta_4 CA_{it} + \epsilon_{it}$$

(1)

#### **Result & Discussion**

**Table 2: Descriptive Statistics**

Variable	Mean	Std. Dev.	Min	Max
ESG	38.45	12.34	10.20	72.89
ROA	7.82	5.67	-19.43	29.56
CA	18.76	6.89	0.23	22.45

FS	8.91	1.45	5.67	12.34
CS	45.23	15.78	10.45	85.67

Table 2 shows the results of descriptive statistics. To handle the outliers all the variables are winzorized at 1%. The tables show that ESG disclosure value ranges from 10.20 to 72.89 with the average ESD disclosure score of the European manufacturing firms, which is 38.45. Similarly, the performance of the firm on average is 7.82 percent while the values range between -19.43 to 29.56 percent. This range indicates that non-financial firms considered in this study fall into a struggling and a thriving range. On average the European manufacturing firms fund their business with 45.23 percent through debt financing. While these firms have 18.76 percent plant assets or productive assets in comparison to their asset structure.

**Table 3: Correlation Analysis**

Variable	ESG	ROA	CA	FS	CS
ESG	1.000				
ROA	0.452***	1.000			
CA	0.387**	0.310**			
FS	0.510**	0.298**	0.342***	1.000	
CS	0.125	-0.175*	-0.198*	0.275**	1.000

Note \*\*\*, \*\*, \* means 1%, 5% and 10%

Table 3 shows the results of correlation analysis. The values show that ESG has a significant positive correlation with ROA. The strength of the association is moderate in nature. While ESG has the highest strength of the association with FS (0.510) suggesting that larger firms tend to perform better financially and prioritize ESG initiatives. ROA has a positive association with CA which means for the firm productive assets are very important. CS has a weak positive but insignificant association with ESG (0.125) but negative associations with ROA (-0.175) hinting that higher debt financing hinder profitability.

**Table 4: Fixed Effect Panel Regression**

Variable	Coefficient	VIF
Constant	2.345 (0.678)***	
ESG	0.087 (0.012)***	1.45
FS	0.156 (0.045)***	1.72
CS	-0.023 (0.008)***	1.89
CA	0.045 (0.019)***	1.63
<b>R-squared</b>	0.672	
<b>Adjusted R-squared</b>	0.658	
<b>F-Statistic</b>	45.23***	
<b>Pesaran CD</b>	0.89 (0.374)	
<b>DW</b>	2.03	
<b>Hausman Test</b>	45.78***	

Note \*\*\*, \*\*, \* means 1%, 5% and 10%

Table 4 shows the results of fixed effect panel regression. 67% of the overall change in the ROA is explained by this model while the

remaining changes in the firm's performance are due to the factors not considered in this model. F-statistic show that model is fit and beta coefficients are reliable. There is no issue of cross sectional dependance which is confirmed by the Pesaran CD test. Similarly, there is no issue of autocorrelation and multicollinearity as confirmed using Durbin-Watson (DW) statistics and VIF test.

The results confirmed that ESG has a significant positive impact on firm performance (Ademi & Klungseth, 2022; Biju et al., 2025). With one score increased in the overall ESG of the firm profitability increased by 0.087 units. It shows that firms engaging in sustainable and responsible business practices are better positioned to enhance performance, possibly due to improved stakeholder trust, risk management, and operational efficiencies (Ademi & Klungseth, 2022; Malik & Kashiramka, 2024; Miralles-Quirós et al., 2019).

In this study, the impact of FS, CS and CA is controlled. They have a significant impact on firm performance. FS has a positive significant relationship confirming that large firms have enhanced operational efficiencies, resource availability, market dominance, or better risk diversification. Larger firms may also face more pressure and scrutiny from stakeholders, motivating them to invest more heavily in ESG initiatives (Malik & Kashiramka, 2024). However, CS have a negative relationship with ESG, which highlights that increased use of debt funds leads to greater financial risk and restrict managerial flexibility, ultimately diminishing firm profitability. While CA has a significant positive association with firm performance, meaning that firms with higher capital investments tend to have higher profitability. The rationale behind this outcome is that firms having more productive assets get competitive advantages over their competitors due to high productivity potential (Javaid & Raza, 2025). Along with that capital-intensive firms operate with greater environmental exposure, making ESG investments more relevant and impactful for performance.

The findings highlight that ESG disclosures enhance profitability for European firms, aligning with stakeholder theory. Transparent ESG practices foster trust, reduce information asymmetry, and improve access to favorable financing, as lenders reward firms with lower capital costs (Eliwa et al., 2021). ESG disclosures significantly influence profitability and valuation by alleviating investor concerns about ecological risks, positioning these activities as strategic investments rather than costs. Managers should prioritize ESG communication through diverse channels, such as corporate websites and sustainability reports, to enhance accessibility and reduce information costs for stakeholders. During crises, ESG practices may be viewed as costly (Lu & Khan, 2023). For managers, prioritizing ESG disclosures can enhance profitability, providing a competitive edge. Investors benefit from incorporating ESG metrics into decisions, as firms

with strong ESG performance often achieve higher valuations. Policymakers should strengthen ESG regulations, such as the EU's Corporate Sustainability Reporting Directive (CSRD), to promote transparency and support sustainable practices through incentives.

### **Conclusion**

This study underscores the growing significance of ESG disclosures in enhancing firm profitability, particularly within the European manufacturing sector. Grounded in Stakeholder Theory, the findings reaffirm that firms engaging in transparent and responsible ESG practices not only address broader societal and environmental concerns but also build stronger relationships with key stakeholders. These disclosures reduce information asymmetry, foster trust, and improve access to capital factors that collectively contribute to improved financial performance.

Moreover, the Trade-Off Theory provides insight into the nuanced relationship between ESG activities and performance by acknowledging the cost-benefit balance inherent in such engagements. When firms invest in ESG up to an optimal level, the benefits—such as risk mitigation and reputational gains tend to outweigh the associated costs. Similarly, the RBV supports the notion that ESG integration serves as a unique strategic resource, offering a sustained competitive advantage that drives long-term value creation.

From a practical standpoint, the results suggest that corporate managers should view ESG disclosures not as a regulatory burden but as a strategic lever to improve operational efficiency, financial resilience, and to gain stakeholder trust. Enhancing the quality and accessibility of ESG information—via sustainability reports, investor briefings, and digital platforms—can significantly influence stakeholder perceptions and investment decisions.

Policymakers, too, have a pivotal role in advancing sustainable practices by reinforcing disclosure frameworks. Collectively, these implications emphasize that ESG engagement, when strategically aligned and effectively communicated, not only supports ethical corporate conduct but also serves as a robust driver of financial performance in today's competitive global environment.

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