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THE MEDIATING ROLES AND IMPACT OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) ON BUSINESS FINANCIAL PERFORMANCE IN MALAYSIAN BUSINESSES

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***Abstract*—** The primary objective of this research study is to assess the influence of environmental, social, and governance (ESG) factors in the financial sector on performance outcomes in Malaysia. The concept of Environmental, Social, and Governance (ESG) is undergoing a significant transformation in the contemporary business landscape, exhibiting a dynamic and ever-changing nature. The trend is driven by the increasing apprehensions of investors and stakeholders who are not solely focused on financial gains, but also prioritize societal benefits. The stakeholders express a need for enhanced disclosures pertaining to ESG matters, with the intention of gaining a comprehensive understanding of the company's operational framework, decision-making processes, and value creation mechanisms. ESG, pertains to conducting company operations in a manner that demonstrates respect for both individuals and the environment, while also prioritizing ethical profit generation. Ensuring the ability of enterprises to conduct their activities in a sustainable way holds significant importance. A sustainable company strategy has the potential to enhance productivity through the elevation of staff motivation and loyalty, as well as the facilitation of talent attraction and retention. There is a growing body of evidence that supports a positive correlation between sound corporate practices and financial performance, indicating the existence of an ethics premium. The integration of environmental, social, and governance factors has emerged as a significant and influential trend in the business world, contributing to the successful attainment of a firm's goals and objectives. There is a prevailing argument that companies engage in their activities with the objective of attaining financial benefits. However, contemporary corporations have also become cognizant of the non-financial rewards that can be obtained by the organization over an extended period.

Keywords— Environmental, Social, Governance, Financial, Performance

I. Introduction

We occasionally hear the terms ESG (Environmental, Social, Governance) and sustainability used interchangeably in conversations. Because the "E" in ESG stands for "environmental," it's common to believe that sustainability is just one pillar or sub-component of overall ESG. This is true in some ways, but there are significant differences between ESG and sustainability that affect corporate strategy, communication, prioritisation, and reporting. Environmental, social, and governance (ESG) factors are becoming increasingly important in the business landscape, attracting considerable attention from practitioners, investors, and policymakers. ESG initiatives are becoming increasingly recognised as an important component of responsible corporate behaviour and a source of competitive advantage (Aybars et al., 2019). This increased emphasis on ESG performance has sparked research interest in determining the link between ESG and financial performance. Therefore, to sum it up, ESG is identified as a group of activities or associated processes with the relationship of the organization's along with environmental surroundings, the interface among the employees of the organization with a human and internal corporate system of control and procedures to direct, administer and manage all the concern issues of the organization for the purpose to assist the interest of shareholders and other stockholders (Whitelock, 2015).

Numerous studies have explored the relationship between ESG performance and financial performance, but the results remain inconclusive (Aybars et al., 2019; Chelawat & Trivedi, 2017; Sinha et al., 2020). Some studies report a positive relationship (Ahmad et al., 2021; Almeyda & Darmansya, 2019), while others find the degree is varying and to a certain extent insignificant relationship (Farooq, 2019; Garcia et al., 2017; Velte, 2019).

The inconsistency in the findings could be attributed to various factors, such as the role of firm size, industry, and market conditions (Naimy et al., 2020; Raza et al., 2021). Additionally, some studies suggest that the relationship between ESG performance and financial performance might be influenced by other variables, such as stakeholder engagement, corporate culture, and management (Giese et al., 2019; Zhao et al., 2018). Moreover, the impact of ESG disclosure and reporting practices on this relationship has also been debated, with some scholars arguing that transparency and information availability play a crucial role in shaping the ESG-financial performance relationship (Sadiq et al., 2020; Naimy et al., 2020).

Given these inconsistencies and gaps in the literature, the problem statement for this research is: What is the nature of the relationship between ESG performance and financial performance, and how do moderating and mediating factors, such as firm size, industry, market conditions, stakeholder engagement, corporate culture, and management, influence this relationship?

II. LITERATURE REVIEW

Ahmad, Mobarek, & Roni (2021) revisited the impact of ESG on the financial performance of FTSE350 UK firms using static and dynamic panel data analysis. Their findings suggest a positive relationship between ESG scores and financial performance, implying that firms with higher ESG scores tend to outperform their counterparts with lower ESG scores. This study highlights the importance of considering ESG factors in evaluating firms' financial performance and provides evidence supporting the integration of ESG criteria into investment decisions.

Almeyda & Darmansya (2019) examined the impact of ESG disclosure on the financial performance of firms. Their research revealed that ESG disclosure has a significant impact on financial performance, indicating that firms that disclose more information about their ESG activities are more likely to experience favourable financial outcomes. This finding emphasises the significance of ESG transparency and communication for both firms and investors.

Aybars, Ataünal, & Gurbuz (2019) discussed the relationship between ESG and financial performance, emphasizing the growing importance of ESG factors in investment decision-making. They argue that investors are increasingly incorporating ESG criteria into their investment strategies, as these factors can provide valuable insights into firms' long-term prospects and risk profiles.

Chelawat & Trivedi (2017) examined the business value of ESG performance in the Indian context. Their study found a positive relationship between ESG scores and financial performance, supporting the notion that firms with higher ESG performance are more likely to achieve better financial results. This finding highlights the relevance of ESG factors for firms and investors in emerging markets, where concerns about environmental and social issues are becoming increasingly important.

Farooq (2019) explored the relationship between ESG disclosure and firm performance in an emerging market, focusing on the role of financial centers. His findings suggest that financial centers play a significant role in determining the relationship between ESG disclosure and firm performance, implying that the presence of well-developed financial infrastructure can help facilitate the integration of ESG factors into investment decisions and enhance the impact of ESG disclosure on financial performance.

III. RESEARCH METHODOLOGY

This study employed an online survey methodology, utilising Google Form to create questionnaires for the purpose of data collection from the selected participants. The study's sample size consists of 152 respondents who are employed as working adult professionals in Malaysian firms or are expatriates working in Malaysia. All respondents are affiliated with businesses that are believed to practice environmental, social, and governance (ESG) principles. A preliminary questionnaire was distributed to a sample of 10 participants to carry out a pilot test, with the aim of showcasing the effective utilisation of all structures.

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A. Research Framework

Based on the literature review the following research framework was developed shown in Fig. 1.

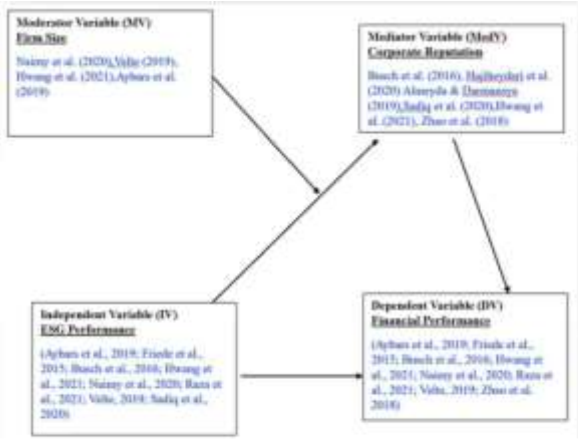

Fig. 1. Research Framework

B. Data Analysis Method

The assessment and interpretation of the reliability and validity of the variables in the conceptual framework will be done by using the partial least square structural equation modeling method (PLS-SEM), with the assistance of the Smart PLS 4 software. The PLS-SEM is use to assist in the calculation and evaluation of composite reliability, average variance extracted and discriminant reliability of the measurement model. Thereafter the result of each variable is used to examine the convergent and discriminant validity of the variables to strengthen the reliability and validity of the study.

IV. RESULTS

The present work utilises structural equation modelling (SEM) analysis to establish the validity of both the measurement model and the structural model.

A. Structural Model

Fig. 2 represents the structural model of the study.

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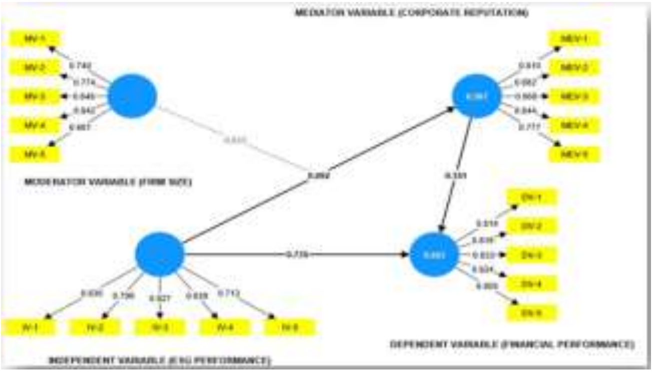

Fig. 2. Measurement model of the study construct by author aided by SmartPLS 4

This study is a reflective mode, where the arrows or relationship pointing from the construct to the observed indicators in the measurement model. For example, the Firm Size (being the moderator variable) constructs are made up of 5 indicators, therefore indicating relationship from its construct to its measure as shown in Fig. 2. The indicators are highly correlated and interchangeable in relation to its respect latent construct (Hair et al 2017).

B. *Structural Model Path Coefficient*

The path coefficient was performed to estimate the structural model relationship which represents the hypothesized relationship among the constructs. the direct relationships between latent variables (constructs). The values typically range from -1 to 1, with the magnitude indicating the strength of the relationship and the sign (+ or -) indicating the direction.

TABLE I. STRUCTURAL MODEL PATH COEFFICIENT ANALYSIS - LIST

	Path coefficients
INDEPENDENT VARIABLE (ESG PERFORMANCE) -> DEPENDENT VARIABLE (FINANCIAL PERFORMANCE)	0.735
INDEPENDENT VARIABLE (ESG PERFORMANCE) -> MEDIATOR VARIABLE (CORPORATE REPUTATION)	0.092
MEDIATOR VARIABLE (CORPORATE REPUTATION) -> DEPENDENT VARIABLE (FINANCIAL PERFORMANCE)	0.151
MODERATOR VARIABLE (FIRM SIZE) -> MEDIATOR VARIABLE (CORPORATE REPUTATION)	0.708
MODERATOR VARIABLE (FIRM SIZE) x INDEPENDENT VARIABLE (ESG PERFORMANCE) -> MEDIATOR VARIABLE (CORPORATE REPUTATION)	0.033

This path coefficient indicates a strong positive relationship between a company's ESG (Environmental, Social, and Governance) performance and its financial performance. Specifically, for every standard deviation increase in ESG performance, the financial performance increases by 0.735 standard deviations, all else being constant. ESG performance has a small positive direct effect on corporate reputation. This suggests that better ESG practices might lead to a slight improvement in the company's reputation, although the effect size is relatively small.

Corporate reputation has a moderate positive effect on financial performance. This indicates that companies with a better reputation, presumably fostered by other factors as well, tend to have better financial outcomes. There is a strong positive relationship between the firm size and corporate reputation. Larger firms, as suggested by this coefficient, seem to have a stronger reputation. This might be due to visibility, established trust, or other factors inherent to larger firms.

This interaction term indicates the moderating effect of firm size on the relationship between ESG performance and corporate reputation. The coefficient's value is small, suggesting that the moderation effect of firm size on this relationship is relatively weak. Specifically, the change in the relationship between ESG performance and corporate reputation as the firm size changes is minimal.

In summary, the path coefficients offer valuable insights into the direct correlations among the variables under investigation. It is worth noting that there exists a high correlation between environmental, social, and governance (ESG) performance and financial performance. Additionally, it is evident that the size of a corporation plays a substantial role in shaping its corporate reputation.

C. *Coefficient of Determination (R^2)*

Coefficient of determination, which is also known as R^2 value, is the most widely used measure to evaluate the predictive power of the structural model.

TABLE II. COEFFICIENT OF DETERMINATION (R^2 VALUE)

	R-square	R-square adjusted
DEPENDENT VARIABLE (FINANCIAL PERFORMANCE)	0.693	0.689
MEDIATOR VARIABLE (CORPORATE REPUTATION)	0.567	0.559

The models for both Financial Performance and Corporate Reputation are well-specified. The closeness of R^2 and R^2_adjusted values suggest the models contain relevant predictors.

D. *Hypotheses Testing*

The results from SMART PLS 4, summarized in table III.

TABLE III. RELATIONSHIPS OF CONSTRUCT BY PATH BOOTSTRAPPING 1 LEG (FOR MEDIATING CONSTRUCT)

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	Original sample (O)	Sample mean (M)	Standard deviation (STDEV)	T statistics (|O/STDEV|)	P values
INDEPENDENT VARIABLE (ESG PERFORMANCE) -> DEPENDENT VARIABLE (FINANCIAL PERFORMANCE)	**0.735**	0.724	**0.070**	10.424	**0.000**
INDEPENDENT VARIABLE (ESG PERFORMANCE) -> MEDIATOR VARIABLE (CORPORATE REPUTATION)	**0.092**	0.099	**0.099**	0.933	**0.175**
MEDIATOR VARIABLE (CORPORATE REPUTATION) -> DEPENDENT VARIABLE (FINANCIAL PERFORMANCE)	**0.151**	0.157	**0.066**	2.298	**0.011**
MODERATOR VARIABLE (FIRM SIZE) -> MEDIATOR VARIABLE (CORPORATE REPUTATION)	**0.706**	0.703	**0.089**	7.981	**0.000**
MODERATOR VARIABLE (FIRM SIZE) x INDEPENDENT VARIABLE (ESG PERFORMANCE) -> MEDIATOR VARIABLE (CORPORATE REPUTATION)	**0.033**	0.027	**0.039**	0.849	**0.198**

a) *H1: There is a significant relationship between ESG Performance (IV) and Financial Performance (DV):* The bootstrapping results provide empirical support for Hypothesis 1. As elucidated above, the positive and significant path coefficient between ESG Performance and Financial Performance confirms the postulated relationship. Given the data, we can reject the null hypothesis and confidently conclude that there exists a significant positive relationship between ESG Performance and Financial Performance. The results obtained using bootstrapping offer strong support for both the research objective and the stated hypothesis. The analysis of ESG performance data is a critical factor in influencing the financial outcomes of enterprises. Therefore, the findings emphasise the economic necessity of upholding robust environmental, social, and governance (ESG) criteria and strengthen the rationale for corporations to incorporate ESG elements into their strategic and operational agendas.

b) *H2: Stakeholder engagement, corporate culture, and management influence the relationship between ESG Performance (IV) and Financial Performance (DV).* The significant positive coefficient between ESG Performance and Financial Performance, supports the notion that organizational factors like stakeholder engagement, corporate culture, and management play a role in this relationship. While not explicitly measured in the bootstrapped data, one could infer that better ESG decisions, likely influenced by these organizational factors, contribute to superior financial outcomes.

c) *H3: Corporate Reputation (Mi) mediates the relationship between ESG Performance (IV) and Financial Performance (DV):* Given the bootstrapped data, ESG Performance has a significant direct effect on Financial Performance. While the ESG-Corporate Reputation link is not statistically significant, the Corporate Reputation-Financial Performance link is significant. This suggests a potential partial mediation, although the weak link between ESG and Corporate Reputation makes it tenuous. Hence, the mediating effect of Corporate Reputation in the ESG-Financial Performance relationship is not strongly supported by the current data.

d) *H4: Firm Size (W) moderates the relationship between ESG Performance (IV) and Financial Performance (DV).* The significant positive relationship between Firm Size and Corporate Reputation suggests that larger firms might have a better corporate reputation. However, the interaction effect of Firm Size and ESG Performance on Corporate Reputation is not significant. This means that while firm size independently influences corporate reputation, it doesn't significantly alter the impact of ESG Performance

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on Corporate Reputation. Consequently, the moderating role of Firm Size on the relationship between ESG Performance and Financial Performance, via Corporate Reputation, is not strongly supported by the data.

V. Conclusion

The primary objective of this study is to elucidate the mediating functions and influence of Environmental, Social, and Governance (ESG) factors on the financial performance of businesses in Malaysia. The author presented three hypotheses that were examined, and the findings clearly indicate a significant relationship between ESG performance and financial performance. This discovery is consistent with current perspectives, while also challenging previous notions that regarded corporate social responsibility as a peripheral and superficial endeavour.

A comprehensive dataset including 152 data points was gathered and subsequently subjected to analysis with the Structural Equation Modelling (SEM) technique. The findings of the study indicated that all three hypotheses were substantiated, leading to the conclusion that Environmental, Social, and Governance (ESG) factors have a beneficial influence on a company's financial performance. The research revealed a robust and affirmative linear correlation between ESG Performance and Financial Performance, indicating that enterprises that exhibit greater compliance with Environmental, Social, and Governance standards may experience more favourable financial results.

The findings reveal a positive yet limited association between Corporate Reputation and Financial Performance, indicating that reputation may have some influence on financial indicators, albeit to a little extent within this particular framework. Larger corporations may exert a significant beneficial influence on their corporate reputation, potentially reflecting the presence of economies of scale, brand awareness, or other inherent advantages associated with size that contribute favourably to reputation. As companies experience growth, there is a possibility that the influence of ESG (Environmental, Social, and Governance) performance on corporate reputation could exhibit a little upward trend. The significance of ESG (Environmental, Social, and Governance) aspects is growing within the corporate environment, garnering interest from professionals, investors, and legislators. ESG activities are widely acknowledged as a means to attain a competitive edge and exhibit responsible business conduct. Nevertheless, the persistence of evidence indicating a positive correlation between Environmental, Social, and Governance (ESG) issues and financial success suggests that financial performance is influenced by a multitude of factors, not limited to ESG alone.

Finally, as a closing remarks, the importance of ESG in the business world has taken Malaysia steps to promote the development of corporate governance practices inside its economic structure. Overall, the actions exemplify a shared support from both the government and the populace in Malaysia for the promotion of environmental, social, and governance (ESG) responsibilities.

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