

## THE IMPACT OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) DISCLOSURES ON FINANCIAL PERFORMANCE OF LISTED COMPANIES: A STUDY OF UNITED ARAB EMIRATES (UAE)

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### ABSTRACT

In the last couple of decades, Environmental, Social, and Governance (ESG) has emerged as one of the most popular non-financial performance matrix for various governments, companies, investors, and other stakeholders around the world. Most of the stakeholders have one common question- do companies' ESG practices and their disclosures have any impact on their performance specially in the context of financial wellbeing. In the same context, this paper attempts to evaluate the ESG disclosures and their impact on financial performance of listed companies in UAE, a prominently progressive economy in MENA region.

To evaluate the relationship, researcher has taken a sample of 51 listed companies on Abu Dhabi Securities Exchange over the period form 2020-2023. As the listed companies started disclosing key ESG parameters majorly in 2020 when UAE Securities and Commodities Authority (SCA) launched Corporate Governance Code for listed companies and instructed them to publish an annual sustainability report.

The Empirical results of this research indicate that the Environment and Social disclosures by UAE listed companies have a positive and significant impact on their financial performance measured mainly in the form of return on assets and returns on equity. Whereas Governance disclosure is found to be negatively but insignificantly associated with companies' financial performance. Therefore, we can infer that in an emerging and progressive country like UAE, ESG disclosure or reporting can help the companies to improve their financial performances.

**Keywords:** *Environmental, Social and Governance disclosures, Financial Performance, return on assets, returns on equity, UAE listed companies.*

**JEL classification:** C32, G33, G34

### INTRODUCTION

The preference towards Environmental, Social, and Governance (ESG) practices in the recent decades has been significantly increased globally primarily due to push by the governments and preference of the conscious investors and other stakeholders (Gao et al., 2022). The concept of Environmental, Social, and Governance (ESG) came into limelight for the first time in 2004 by

United Nations (UN) releasing a report titled "Who Cares Wins" which coined the concept at international level. Since then ESG theme has grown multifold with governments' efforts mainly as tool to become carbon neutral with their own set of country or industry level targets. Globally ESG has evolved today as a metric for the evaluation of companies' activities and efforts to safeguard environment, take care of society and govern the organisation in most fair and lawful manner (Shakil, 2021; Gao et al., 2023).

ESG framework, which was earlier limited to governments' economic policies, has now started making the mark in financial markets too. ESG conscious and socially responsible, impact investors today prefer ESG active and transparent companies over non-ESG active or companies with negative ESG impacts (Gao et al., 2023). Such investors' preferences further pushed many stock exchange regulators to introduce ESG matrices for companies to be followed. Although few countries implemented them as mandatory guidelines while a majority of stock exchanges follow them at voluntary level. As per 2021 report by Sustainable Stock Exchange Initiative (SSEi), 106 stock exchanges around the world have introduced ESG disclosures as voluntary guidelines while 26 exchanges made them mandatory for listed companies (SSEi, 2021).

### **ESG guidelines for listed companies in United Arab Emirates (UAE)**

In early 2020, the UAE took the initiative to encourage companies to invest in sustainable future and began to draft the framework for engaging UAE listed companies in ESG practices in line with UN's Sustainable Development Goals (SDGs) and also introduced voluntary guidelines for listed companies to report on their ESG activities and efforts. As a result, Securities and Commodities Authority (SCA) of UAE introduced Corporate Governance Code for listed companies and instructed them to publish an annual sustainability report. Article 76 of the Governance Code specified that these reports should comprehensively address- how the operational activities of the companies impact the environment, society, and the governance. They should also showcase their constructive effects on society and the local economy. In order to develop a standardised approach in reporting, listed companies were required to follow ESG reporting codes as notified by the Abu Dhabi Securities Exchange (ADX) and the Dubai Financial Market which were in line with globally accepted ESG standards.

Subsequently, ADX joined the list of partner exchanges of Sustainable Stock Exchanges (SSE) which is an initiative of the United Nations to promote sustainability among financial markets among the member countries. Although, as of today, UAE's ESG disclosure guidelines are voluntary in nature with 31 ESG indicators but the regulators have already initiated a discussion to make it as a mandatory practice among listed companies. UAE's ESG indicators are mainly aligned to Global Reporting Initiative (GRI) for the Sustainable Development Goals (SDGs) which is a collaborative initiative of United Nations Member countries since 2015. In the last several years, UAE has progressed significantly on ESG parameters which has drawn the attention of Socially responsible impact investors. But all these reporting requirements are limited to publicly

listed Joint Stock Companies, whereas private enterprises are yet to be encouraged and guided in line with public listed companies.

## LITERATURE REVIEW

Sustainable Development Goals (SDG) as initiated by United Nations and supported by member countries have boosted the socially responsible investing (SRI) and impact investing (II) preferences among investors. And as a result, financial markets around the world are taking initiatives to implement ESG guidelines (Alsayegh, Rahman, & Homyoun, 2020). According to an estimate, SRI and II types of investments have grown significantly from \$18.23 Trillion in 2014 to \$35.3 Trillion in 2020 (Statista, 2024). The significant growth in such ESG linked investments indicate that now a days, investors, not just look for financial gains but also consider non-monetary performances for greater good.

Although, a majority of this growth in investments belongs to USA (\$17 Tn) and Europe (\$12 Tn) but countries like Japan, Canada, New Zealand, and Australia are also on growth path. Most of the developing countries in Asia and MENA region are in their nascent stage of ESG adoption, but ESG investors' interests are emerging in these markets as well. Thus, considering the growing ESG preferences, it becomes important for the countries to prepare their financial market for ESG disclosures. It will facilitate the investors to make informed decisions as per their preferences and align their investment portfolio to their ESG objectives.

As most of the external stakeholders are in favour of ESG efforts and disclosures but companies often ask the question- what may be the direct and indirect benefits and disadvantages of these practices. Various previous studies in this context, indicate that although ESG efforts and disclosure bring some additional costs to organisations but overall it enhances the market value of the firm (Batae, et. al., 2020). It is generally observed that most of the costs are immediate in nature while returns are mainly long term. Most of the investors who choose to invest on the basis of ESG criteria, they tend to have more patience and are ready to sacrifice short term profitability for long term gains (Dorfleitner, et. al. 2020). Similarly, several studies indicate that ESG efforts and disclosures have positive impact on business development, risk mitigation and also help to achieve higher as well sustainable returns for investors (Naeem and Cankaya, 2022).

Although many previous studies support the construct that ESG disclosures positively impact the financial performance of companies but there are few studies which show contradictory results e.g. Farooq (2015) shown that ESG disclosures had negative impact on financial performance of selected Indian companies particularly in Mumbai, Maharashtra while found insignificant impact among the companies from other selected cities of India. Buallay (2018) on the other hand, found that overall ESG scores positively associated with financial performances of the companies in Europe. But when tested individual scores of environment, social and governance, it was revealed that governance scores were negatively related to financial performance. Similar findings were also reported by Shakil et. al. (2019) where the financial performance of 93 banking institutions

from developing countries were evaluated against their ESG disclosure practices. The study reported that Environment and Social disclosures were positively associated with financial performance whereas governance was negatively associated.

## RESEARCH METHODOLOGY

To assess the relationship between UAE listed companies' environmental, social and governance (ESG) disclosures and their financial performance, regression analysis was selected which was in line with Xie et al. (2018). ESG scores were considered as independent variables and for financial performance of firms, return on equity (ROE) and return on assets (ROA) were selected as the dependent variables. Size of the firm, age of the firm and financial leverage of the firm were kept as control variables.

The ESG scores were sourced from Bloomberg's proprietary thematic scores that rate the companies around the world on the scale of 1 to 100 for their ESG disclosures and efforts. 1 being the least transparent and 100 being the most transparent for disclosing ESG to external stakeholders. There were 3 scores that were sourced for each company namely- Environmental score, social score, and Governance score. Similarly, for the financial performance for same set of selected companies, return on equity (Net income divided by total equity as percentage) and return on assets (Net income divided by total assets as percentage) were calculated and used as dependent variables. Thus, the study has adopted the following definitions of various dependent, independent, and control variables:

<b>Dependent, Independent and Control Variables</b>	<b>Definitions</b>
ROA (Return on Assets)	Profit after Taxes (PAT) divided by total assets of the firm
ROE (Return on Equity)	Profit after Taxes (PAT) divided by total shareholders' equity of the firm
Firm's Environment scores	Bloomberg's proprietary thematic environment score (between 1 and 100)
Firm's Social scores	Bloomberg's proprietary thematic social score (between 1 and 100)
Firm's Governance scores	Bloomberg's proprietary thematic governance score (between 1 and 100)
Size of the firm	log of firm's total assets.

Age of the firm	Number of years since the company listed on the stock market.
Financial Leverage of the firm	Firm's total Liabilities divided by total shareholders' equity.

Table-1: definitions of various dependent, independent, and control variables

### Establishing Hypotheses

As per the outcomes of previous studies in the area of ESG disclosures and financial performance, the following studies supported the positive relationships with different ESG discloses and financial performance benchmarks:

Previous studies	Concluded relationship between ESG and Financial Performance of firms
Carnini et. al. (2022), Dalal & Thaker (2019), Friede et. al. (2015), Yu et al. (2018),	Environment disclosures are positively and significantly related to Firm's ROE and ROA.
<p><b>Hypothesis 1:</b> Environment disclosures has positive relationship with financial performance of the firm.</p> <p><b>H1a:</b> Firms' Environment scores have significant &amp; positive relationship with return on equity.</p> <p><b>H1b:</b> Firms' Environment scores have significant &amp; positive relationship with return on assets.</p>	
Arx et. al. (2008), Brammer & Millington (2008), Carnini et. al. (2022), Dalal & Thaker (2019), Friede et. al. (2015), Genedy & Sakr (2017), Yu et. al. (2018),	Social disclosures are positively and significantly related to Firm's ROE and ROA.
<p><b>Hypothesis 2:</b> Social disclosures has positive relationship with financial performance of the firm.</p> <p><b>H2a:</b> Firms' Social scores have significant &amp; positive relationship with return on equity.</p> <p><b>H2b:</b> Firms' Social scores have significant &amp; positive relationship with return on assets.</p>	
Alareeni et. al. (2020), Carnini et. al. (2022), Dalal & Thaker (2019), Friede et. al. (2015), Goel (2018), Yu et al. (2018),	Governance disclosures are positively and significantly related to Firm's ROE and ROA.
<p><b>Hypothesis 3:</b> Governance disclosures has positive relationship with financial performance of the firm.</p>	

**H3a:** Firms’ Governance scores have significant & positive relationship with return on equity.  
**H3b:** Firms’ Governance scores have significant & positive relationship with return on assets.

*Table-2: Development of Hypotheses*

**Regression Equation**

With the help of identified dependent, independent and control variables from literature, the following two separate regression equations were developed to test the relationship between firm’s ROA and independent variables and firm’s ROE and independent variables.

$$\text{ROA} = \alpha + \beta_1 \text{ES} + \beta_2 \text{SS} + \beta_3 \text{GS} + \beta_4 \text{AG} + \beta_5 \text{LV} + \beta_6 \text{SZ} + e \dots\dots\dots\text{i}$$

$$\text{ROE} = \alpha + \beta_1 \text{ES} + \beta_2 \text{SS} + \beta_3 \text{GS} + \beta_4 \text{AG} + \beta_5 \text{LV} + \beta_6 \text{SZ} + e \dots\dots\dots\text{ii}$$

**Where as**

- ROA = Firm’s Return on Assets
- ROE = Firm’s Return on Equity
- ES = Environmental score
- SS = Social score
- GS = Governance score
- AG = Age of the firm
- LV = Financial Leverage of the firm
- SZ = Size of the firm
- e = error terms
- $\alpha$  = constant

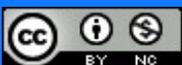
**RESULTS AND ANALYSIS**

**Correlation analysis**

Before running the regression models, the researcher tested for the correlation between various ESG disclosure related independent variables, financial performance related dependent variables and other control variables. The following tables summarise the correlation results:

**Relationship between ESG disclosures and Return on Assets (ROA)**

	<b>ROA</b>	<b>ES</b>	<b>SS</b>	<b>GS</b>	<b>AG</b>	<b>LV</b>	<b>SZ</b>
Return on Assets (ROA)	1						
Environmental Score (ES)	0.127	1					
Social Score (SS)	0.171	0.317	1				



Governance Score (GS)	-0.245	0.108	0.211	1			
Firm age (AG)	0.310	-0.624	-0.087	-0.276	1		
Firm Leverage (LV)	-0.201	-0.278	0.011	0.347	0.475	1	
Firm Size (SZ)	0.311	-0.297	0.320	-0.145	0.210	0.312	1

Table-3: ESG disclosures and Return on Assets (ROA)

### Relationship between ESG disclosures and Return on Equity (ROE)

	ROE	ES	SS	GS	AG	LV	SZ
Return on Equity (ROE)	1						
Environmental Score (ES)	0.197	1					
Social Score (SS)	0.296	-0.478	1				
Governance Score (GS)	-0.270	-0.089	0.317	1			
Firm age (AG)	0.051	-0.513	0.083	0.197	1		
Firm Leverage (LV)	0.314	0.597	-0.618	-0.092	-0.315	1	
Firm Size (SZ)	-0.091	-0.167	-0.294	0.007	0.219	0.421	1

Table-4: ESG disclosures and Return on Equity (ROE)

The test of correlation indicates that relationship between various ESG related independent variables and financial performance related dependent variables. As per the results, Environment disclosure scores have positive but slightly weak correlation with Return on Assets and Return on Equity with values of 0.127 and 0.197 respectively. Whereas Social disclosure scores also have similar positive relationships with ROA and ROE i.e. 0.171 and 0.296. On the other hand, Governance disclosure scores were found to have negative correlation -0.245 with ROA and -0.270 with ROE.

Therefore, we can infer that Governance disclosures seem to have negative correlation with financial performance variables of the firm among all three ESG disclosure dimensions.

### Multicollinearity

To the test the reliability of statistical inferences from the model, the independent variables' multicollinearity was tested through variance inflation factor (VIF) based on the equation:

$$VIF q = 1 / (1 - q)$$

A correlation coefficient (q) was then calculated by regressing q on the other explanatory independent and dependent variables in the proposed regression model.

Variable	Coefficient Variance	Centered VIF
C	0.412143	NA
Environmental Score (ES)	0.171214	1.176417
Social Score (SS)	0.271340	1.711354
Governance Score (GS)	21.84216	2.315424
Firm age (AG)	7504421.	1.497541
Firm Leverage (LV)	3154872.	2.713257
Firm Size (SZ)	0.21461	1.682145

*Table-5: Multicollinearity test*

As the VIF values of all tested variables are less than 5, therefore, it can be concluded that there is no significant multicollinearity among the variables, and they can be modelled for further analysis for reliable statistical inferences.

### Regression analysis

Before proceeding with regression analysis, two sets of estimates- fixed effects and random effects models were analysed with Hausman test. The test condition was chosen to be at 5% significance level which means that if the p value is less than 0.05, the fixed effects model will be used, otherwise, the random effects model will be selected for further analysis.

### Hausman Test: ESG disclosures and Return on Assets

Test Summary	Cross-section random
Chi-Sq. Statistic	21.347
Chi-Sq. d.f.	8.694
Prob.	0.0823

*Table-6: Hausman Test: ESG disclosures and Return on Assets*

The Hausman test for ESG and ROA was found to be insignificant as the p value was above 0.05, Thus, random effects model was chosen for evaluating the impact of ESG disclosures on Return on assets.

### Hausman Test: ESG disclosures and Return on Equity

Test Summary	Cross-section random
Chi-Sq. Statistic	16.73
Chi-Sq. d.f.	8.217
Prob.	0.0715

Table-7: Hausman Test: ESG disclosures and Return on Equity

Similarly when the Hausman test for ESG disclosures and Return on equity was conducted, it was found to be insignificant (i.e. p value being greater than 0.05). Therefore, for analysing the impact of ESG disclosures on Return of assets, random effects model need to be selected.

After conducting Hausman test, the random effect models were tested for relationships between ESG disclosures and ROA and ROE respectively.

### Regression-1: ESG disclosures and Return on Assets (Random Effects Model)

Dependent Variable: Return on Assets, Method: Least Squares, Sample: 2020-2023				
Variable	Coefficient	Std. Error t-Statistic		Prob.
C	18.945	29.124	0.784	0.517
Environmental Score (ES)	11.547	17.564	3.14	0.001
Social Score (SS)	11.231	16.245	3.21	0.001
Governance Score (GS)	-9.372	0.0010	-2.71	0.067
Firm age (AG)	0.00487	1.9874	-0.00	0.895
Firm Leverage (LV)	-0.12148	0.9122	-2.19	0.008
Firm Size (SZ)	-9.547	0.0004	-0.57	0.724
R-squared	0.37645			
Adjusted R-squared	0.294512			
Prob (F-statistic)	0.0193214			

Table-8: ESG disclosures and Return on Assets (Random Effects Model)

The regression model-1 for testing relationship between ESG disclosures and Return on assets shows that Adjusted R Square value defining the impact of ESG disclosures on ROA is 0.294512,

which means that 1 percent change in ESG disclosures will lead to 0.29 percent change in firm’s return on assets.

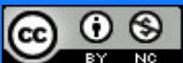
The respective coefficient values of 11.547 & 11.231 and p value of 0.001 suggest that the environment and social disclosures have positive and significant impact on return on assets. Whereas the same interpretation cannot be made in the case of governance disclosure as coefficient value for governance is negative: -9.372 which means it shares the negative relationship with return on assets but as the p value is greater than 5% i.e. 0.067, we cannot consider this as a significant impact.

**Regression-2: for ESG disclosures and Return on equity (Random Effects Model)**

Dependent Variable: Return on Equity, Method: Least Squares, Sample: 2020-2023				
Variable	Coefficient	Std. Error t-Statistic		Prob.
C	47.64	56.54	0.293	0.0248
Environmental Score (ES)	13.58	34.27	4.145152	0.018
Social Score (SS)	17.645	37.54	5.345144	0.006
Governance Score (GS)	-17.245	53.79	-3.341254	0.0832
Firm age (AG)	28.25	73.43	0.962154	0.3971
Firm Leverage (LV)	5214.365	17.547	2.964851	0.0504
Firm Size (SZ)	1.973657	0.521	-3.02145	0.0384
R-squared	0.36124			
Adjusted R-squared	0.276548			
Prob (F-statistic)	0.0174515			

*Table-9: ESG disclosures and Return on equity (Random Effects Model)*

Similarly, The regression model-2 tests the relationship between ESG disclosures and Return on equity. From the values of the regression coefficient in this model, it can be inferred that environment and social disclosures have positive and significant impact on return on equity with respective coefficient values of 13.58 & 17.645 and p value of 0.018 and 0.006. Whereas governance disclosure seems to have negative relationship with return of assets as it has negative coefficient value of -17.245 but as the p value is 0.0832 which is higher than 0.05 of testing value, we cannot consider it significant impact.



The relationship between ESG disclosures and Return on equity shows that Adjusted R Square value defining the impact of ESG disclosures on ROA is 0.276548, which means that 1 percent change in ESG disclosures will lead to 0.276 percent change in firm’s return on equity.

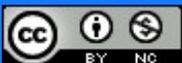
**Hypotheses testing:**

Thus, on the basis of the results of random effects models, we can confidently say that Environment and Social disclosures have significant positive relationships with Return on Equity and Return of Assets. Therefore, Hypotheses- H1a, H1b, H2a, and H2b can be accepted. Whereas, because the governance disclosures found to be negative and insignificant in random effects models, thus we can reject the hypotheses- H3a and H3b.

Hypothesis	Hypothesized relation	Results
H1 a	Firms’ Environment scores have significant & positive relationship with return on equity.	Accepted
H1 b	Firms’ Environment scores have significant & positive relationship with return on assets.	Accepted
H2 a	Firms’ Social scores have significant & positive relationship with return on equity.	Accepted
H2 b	Firms’ Social scores have significant & positive relationship with return on assets.	Accepted
H3 a	Firms’ Governance scores have significant & positive relationship with return on equity.	Rejected
H3 b	Firms’ Governance scores have significant & positive relationship with return on assets.	Rejected

**CONCLUSION**

The empirical results of this study conclude that companies’ environment and social disclosures have significant and positive relationships with their financial performance. Therefore, in the context of UAE listed companies, we can recommend that companies should focus on more environment and social disclosures to enhance their financial performance. However, we cannot conclude the similar relationship between governance disclosure and firm’s financial performance as this relationship was found to be negative and insignificant. Therefore, companies need to be cautious while being too much transparent about their governance.



The results also suggest that companies cannot consider ESG efforts and disclosure expenses as futile. Because environment and social disclosures have positive impact on financial performance, there would be possibilities to earn more long term returns such ESG investments.

## FUTURE DIRECTIONS

As the current study was conducted with a brief period of data and with the sample of listed companies of UAE, the researcher suggests conducting long term and extended studies which include private enterprises also. There will also be value in conducting comparative studies within various industries and sectors of UAE or comparison among other countries in MENA region.

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