Financial Centers And The Relationship Between ESG Disclosure And Firm Performance: Evidence From An Emerging Market

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ABSTRACT

Is the disclosure of non-financial information, such as that related to environmental, social, and governance (ESG), important for firm performance in emerging markets? Does the extent of information asymmetries affect the way stock market participants react towards ESG disclosure? This paper answers these questions and shows that ESG disclosure is negatively related to firm performance in environments with lower information asymmetries. We argue that this negative relationship exists because ESG activities are considered as unrelated costs that reduce shareholders profits and wealth. Our results also show no significant impact of ESG disclosure on firm performance in environments with higher information asymmetries. Given that information is less reliable in environments with lower information asymmetries, it is very much possible that ESG disclosure is not valued by stock market participants.

Keywords: Environmental, Social, and Governance (ESG) Disclosure; Firm Performance; Information Asymmetry; Emerging Markets.

INTRODUCTION

Prior literature suggests that any improvement in information disclosure is more valued in environments characterized by higher information asymmetries. Lang et al. (2004), for instance, document a positive valuation effect of analyst following in countries with high information asymmetries. They argue that countries with high information asymmetries have scarcity of information. Therefore, whenever information disclosure improves, it is highly valued by investors. They document the positive valuation effect of information disclosure in countries with higher information asymmetries. In this paper, we document whether asymmetric impact of information disclosure on firm value/performance exists in case of non-financial information, such as that related to environmental, social, and governance (ESG).

This paper measures the information environment of firms by the location of their headquarters. Recent literature documents better information environment for firms headquartered in the financial centers of emerging markets. Farooq and Kamri (2013), for instance, show that firms headquartered in the financial center have higher analyst following than firms headquartered in other cities. They argue that higher analyst following leads to lower information asymmetries for firms headquartered in the financial centers. In another related study, Farooq and El Ouadrhiri (2013) note that firms in emerging markets are, usually, clustered in and around the financial centers. They argue that clustering of firms in the financial center makes it easier for stock market participants to obtain information about these firms relative to firms headquartered elsewhere. They claim that, for any given level of resources, it is relatively cost effective for stock market participants to expend their resources on clustered firms to obtain value relevant information than on dispersed firms. Given their finite resources, it is more efficient for stock market participants to visit operations and talk to employees/managers of large number of clustered firms to obtain information relative to dispersed firms. Frequent visit would also, eventually, translate into development of personal relationships with management of these firms, thereby improving access to private information. Greater density of firms in the financial center, therefore, translates lower information asymmetries for these firms.

In contrast to earlier studies that document the positive impact of disclosure on the performance of firms headquartered in environments with high information asymmetries, we document the opposite. Using ESG disclosure data for firms headquartered in different information environment, our results show that firms headquartered in more transparent information environments are adversely affected by the extent of ESG disclosure. We document negative relationship between performance of firms headquartered in the financial center and ESG disclosure during our sample period in India – one of the most important emerging markets of the world. We argue that this negative relationship between firm performance and ESG disclosure exists is due to the fact that socially responsible activities are considered as a source of competitive disadvantage in a way that stock market participants can consider these as unnecessary costs. Waddock and Graves (1997) argue that ESG related costs reduce shareholders profits and wealth. Campbell (2007) also assumes that ESG activities are akin to a form of corporate charity. These are the activities that are undertaken by firms without any expectations of positive economic returns. Furthermore, ESG disclosure may not be desirable in emerging markets because these activities can be considered as a source of managerial opportunism. Preston and O'Bannon (1997) argue that managers can reduce investment in ESG activities to alter financial statements. Our results are also in line with Farooq et al. (2013) who document a negative impact of ESG disclosure on brand valuations. They also show that the negative impact of ESG disclosure on brand valuation is more pronounced on firms with lower information asymmetries.[1] Our results also show no significant impact of ESG disclosure on firm performance in environments with higher information asymmetries. Given that information is less reliable in environments with lower information asymmetries, it is very much possible that ESG disclosure is not valued by stock market participants.

DATA

This paper documents the relationship between ESG disclosure and firm performance in India. The period under study is between 2005 and 2010. Following sub-sections will describe the data in detail.

Location of Firms

This paper classifies firms into two groups based on the location of their headquarters. The first group constitutes of firms with headquarters in Mumbai (main financial center of India), while the second group consists of firms with headquarters in cities other than Mumbai. One of the reasons behind classifying firms in these two groups is our understanding that Mumbai, being the main financial center, has better information environment than other cities of the country. The data for the location of firm's headquarters is obtained from the Worldscope. Our data shows that almost 30% of Indian firms are clustering in Mumbai. We argue that clustering of firms in Mumbai should lead to lower information asymmetries for these firms relative to other firms.

ESG Disclosure

The data for environmental, social, and governance (ESG) disclosure is obtained from the Bloomberg. Table 1 documents the descriptive statistics for ESG disclosure for firms headquartered in Mumbai and firms headquartered elsewhere during our sample period. Table 1, Panel A, shows that in most industries, the level of ESG disclosure is same for firms in both groups. The only exception is the technology sector where firms headquartered in Mumbai have significantly higher ESG disclosure than firms headquartered elsewhere. Table 1, Panel B, also shows that ESG disclosure for firms headquartered in Mumbai is approximately similar to ESG disclosure for firms headquartered elsewhere. Our results indicate uniformity in ESG disclosure across firms in both groups.

[1] We are aware of the fact that there are numerous studies that associate ESG disclosure with better performance (Beurden and Gossling, 2008; Sanchez and Sotorrio, 2007). Brickley et al. (2002), for example, show that more socially responsible a firm's behavior is, more valuable is the brand.

Table 1. Descriptive statistics for ESG disclosure

Panel A: ESG disclosure within each industry

Industry	Financial Center		Non-Financial Center	
	Mean	Median	Mean	Median
Oil and Gas	29.1617	20.6600	21.5695	22.1050
Basic Materials	17.2800	15.7000	16.4948	15.7000
Industrials	17.3712	15.2900	15.2356	15.2900
Consumer Goods	16.3756	16.1200	20.2625	17.3600
Consumer Services	22.5514	13.2200	-	-
Healthcare	16.0585	16.5300	-	-
Telecommunications	13.4325	13.6400	13.3340	13.1700
Utilities	21.7380	17.3600	14.0828	12.8100
Financials	10.5427	11.8400	14.0627	11.4000
Technology	40.7440	45.8700	32.9655	28.9250

Panel B: ESG disclosure during each year

Year	Financial Center		Non-Financial Center	
	Mean	Median	Mean	Median
2005	16.8391	16.1150	15.7025	15.2900
2006	18.2578	16.1200	16.4370	15.7000
2007	16.5122	14.8800	15.8390	15.7000
2008	17.3959	15.7000	16.6003	15.7000
2009	18.0022	15.7000	16.9536	16.1200
2010	17.8737	15.7000	17.1955	16.4000

Firm Performance

This paper measures performance of a firm by the market-adjusted returns (RET). The market-adjusted returns are the difference between stock returns and market returns. Stock prices and market index are used to calculate the market-adjusted returns. We extract the stock price data and the corresponding market index data from the Datastream. The stock price data and the market index data was obtained for the first and the last day of each year to compute the market-adjusted returns.

METHODOLOGY

The paper documents the effect of the location of a firm's headquarters on the relationship between ESG disclosure and firm performance. More specifically, it documents whether firms headquartered in the financial center of an emerging market exhibit stronger relationship between ESG disclosure and firm performance or not relative to firms headquartered elsewhere. In order to answer this hypothesis, we divide our sample into two groups – firms headquartered in Mumbai (main financial center of India) and firms headquartered in other cities – and estimate a panel regression with firm performance (RET) as a dependent variable and ESG disclosure (ESG) as an independent variable.[2] Furthermore, mindful of the effects that firm-specific characteristics may have on firm performance, we also add number of firm-specific variables in our regression equation as control variables. These variables are general level of governance disclosure (GOVERNANCE), log of firm's market capitalization (SIZE), total debt to total asset ratio (LEVERAGE), earnings per share (EPS), and asset growth (GROWTH). For the purpose of completeness, we also include industry dummies (IDUM) and year dummies (YDUM) in our regression equation. It is important to mention here that we use panel data regression with fixed effects for our analysis. The Hausman test was used to decide between fixed effect and random effects. Our basic regression takes the following form.

$$\begin{aligned} RET &= \alpha + \beta_1(ESG) + \beta_2(GOVERNANCE) \\ &+ \beta_3(SIZE) + \beta_4(LEVERAGE) + \beta_5(EPS) + \beta_6(GROWTH) \\ &+ \sum_{Ind} \beta^{Ind}(IDUM) + \sum_{Yr} \beta^{Yr}(YDUM) + \varepsilon \end{aligned} \tag{1}$$

[2] The inclusion of a dummy variable representing the location of firm's headquarters may introduce an endogeneity problem in the analysis. In order to avoid this problem, we divided the sample in two groups and estimate Equation (1) for both groups.

The results of our analysis are reported in Table 2. Our results indicate that ESG disclosure has significant and negative impact on the performance of firms headquartered in the financial centers. We report significant and negative coefficient of ESG for firms headquartered in Mumbai. Our results indicate that for every unit increase in ESG disclosure, firm performance goes down by 0.0326 basis points. Our results are consistent with Campbell (2007) and Waddock and Graves (1997) who consider CSR activities as a form of corporate charity. Given that charity is done without expectations of positive returns, stock market participants consider CSR as unrelated costs. Therefore, CSR activities adverse impact on firm performance. Surprisingly, we also show that the CSR disclosure does not adversely impact the performance of firms headquartered in the non-financial centers. We report insignificant coefficient of ESG for firms headquartered in cities other than Mumbai. We argue that higher information asymmetries in non-financial centers may reduce the quality of ESG disclosure.

Table 2. Effect of location of a firm's headquarter on the relationship between ESG disclosure and firm performance

	Financial Center	**Non-Financial Center**
ESG	-0.0326**	-0.0112
GOVERNANCE	0.0345*	-0.0019
SIZE	0.4785***	0.4709***
LEVERAGE	-0.0052	-0.0123***
EPS	0.0038	0.0029
GROWTH	0.0001	0.0023*
Year Dummies	Yes	Yes
Industry Dummies	Yes	Yes
No. of observations	443	1070
F-value	49.26	150.11
R^2 within	0.5863	0.5253

Note: The results significant at 10% significance level are followed by *, at 5% significance level by **, and at 1% a significance level by***.

There may be concerns that the results obtained above are confined to certain stocks. For instance, larger stocks have better information environment due to increased interest from stock market participants. As a result, it is possible that the quality of ESG disclosure in large firms is much better than the quality of ESG disclosure in small firms. In order to address these concerns, we divide firms in each group into two sub-groups – firms with above median size and firms with below median size – and re-estimate Equation (1). Our results confirm our previous finding of a negative and significant relationship between ESG disclosure and firm performance in both sub-groups for firms headquartered in the financial center. We report significant and negative coefficient of ESG for a sample of large and small firms headquartered in Mumbai. As was the case before, we also show an insignificant relationship between ESG disclosure and firm performance in a sample of large and small firms headquartered in cities other than Mumbai.

Table 3. Effect of location of a firm's headquarter
on the relationship between ESG disclosure and firm performance in different sub-groups

	Financial Center		**Non-Financial Center**	
	Small Firms	**Large Firms**	**Small Firms**	**Large Firms**
ESG	-0.0524*	-0.03899**	0.0025	-0.0079
GOVERNANCE	0.0201	0.0530**	-0.0056	-0.0040
SIZE	0.5426***	0.5433***	0.4433***	0.3841*
LEVERAGE	-0.0101**	-0.0021	-0.0134***	-0.0096
EPS	0.0115***	0.0008	0.0026	0.0040*
GROWTH	0.0006	-0.0017	0.0011	0.0025
Year Dummies	Yes	Yes	Yes	Yes
Industry Dummies	Yes	Yes	Yes	Yes
No. of observations	232	211	519	551
F-value	20.93	23.44	77.00	61.98
R^2 within	0.5491	0.6304	0.5112	0.5622

Note: The results significant at 10% significance level are followed by *, at 5% significance level by **, and at 1% a significance level by***.

CONCLUSION

This paper documents the effect of ESG disclosure on firm performance in environments characterized by different information asymmetries in India during the period between 2005 and 2010. Our research shows that ESG disclosure is negatively related to firm performance in environments with lower information asymmetries. This negative relationship exists because ESG activities are considered to be unrelated costs by stock market participants in emerging markets. Our results also show no significant impact of ESG disclosure on firm performance in environments with higher information asymmetries. Given that information is less reliable in environments with lower information asymmetries, it is very much possible that ESG disclosure is not valued by stock market participants.

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