

Review Article

Impact of Environmental, Social, and Governance Accounting on Firms' Profitability and Cash Flow In Nigeria

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Abstract - This paper examines the implications of Environmental, Social and Governance (ESG) Dimensions of corporate social responsibility (CSR) performance on firms' profitability (Returns on Assets - ROA) and Cash Flows (Cash Flows Per Share - CFPS) for eight (8) manufacturing firms listed on Nigerian Stock Exchange from 2009 to 2018. The study found that, on average, increased ESG practice is positively associated with firm performance. Environmental and governmental dimensions and practices positively and significantly affect ROA and CFPS, while the Social dimension negatively and significantly affects ROA and CFPS. The study further revealed that the social dimension's negative effect results from investment in community development and philanthropy. It is concluded that overall, high and quality ESG practices improve corporate financial performance in the manufacturing industry in Nigeria. Therefore, it was recommended that managers of manufacturing firms invest in higher environmental, social and Governance performance to reap higher profitability and cash flow performance.

Keywords - Environmental performance, Social Performance, Governance Performance, Profitability, Cash flows.

I. INTRODUCTION

Tending environmental, social, and Governance (ESG) issues have turned into a state of enthusiasm for speculators, shareholders, and governments as a risk management concern. In contrast, firms engaging in these ESG practices have incorporated them into their competitive strategy. The role of ESG information has been discussed in the academic literature for more than 35 years, demonstrating the depth of the quality pertinence of the ESG investments. In recent years, there has been expanding utilization of ESG information by stakeholders, particularly investors. Initially, there was limited information on non-financial data such as ESG disclosures. Nowadays, companies are moving to information sharing to remain competitive as stakeholders' pressures on

environmental issues such as climate change, pollution, and waste are growing significantly (Jamali, 2008).

Companies are aware that ESG disclosure is critical to portray their good reputation and image in meeting the challenge of green issues to their stakeholders. However, ESG information is still largely ignored by many companies, investors, and represents an untapped source to remain competitive. Many existing studies focus or isolate on a single dimension of ESG (Jamali 2008). Limited ESG research study on all three dimensions, environmental, social, and Governance in a single setting. Environmental activities will give an impact on society. Thus, the company should have Governance to be socially responsible. The combination of these three dimensions could strengthen management practices to enhance company performance. Even when empirical findings claim that ESG has a significant positive effect on financial performance; however, to what extent ESG practices influence Nigerian companies' economic performance is still unknown.

CSR's widely recognized interpretation suggests that CSR includes economic, legal, ethical, and philanthropic components (Carroll, 2001). There has been an interest in CSR and its effects on organizations in the last couple of decades. Many studies have been conducted to analyze the effects of CSR on different organizational aspects. The findings of many studies that focused on the relationship between CSR and firm performance are mixed (Mishra and Suar 2010). Some of these studies found a positive relationship, while others reported a negative relationship. In addition, there are differences across the findings of CSR studies conducted in different countries, which makes it difficult to arrive at universal conclusions (Forte 2013; Lambooy 2010). Most of the previous studies in this area focused on financial performance as a measure of firm performance.

There is a unanimous agreement in prior studies that bigger firms have higher CSR (environmental and social) initiatives/investments, translating to higher disclosures (Brammer & Pavelin, 2008; Guidry & Patten, 2012; Qui, Shaukat & Tharyan, 2015). However, within these



scholarships, the relation between firm profitability and CSR dimensions performance have been vague, the impact of CSR disclosure and the granger causality effect of different CSR activities (i.e., environmental, social, and/or Governance) on profitability remains an open empirical discourse, and the influence of environmental, social and Governance practices on firms' Cash flows not widely empirically explored. Finally, vast prior works have measured CRS using environmental and social dimensions (Matsumura & Vera 2014), while the governance dimension has been sparsely considered in the CSR.

Since the empirical results of the impact of CSR disclosure/performance on financial performance are at best mixed, an investigation of such impact is still open to empirical dialogue, especially among large manufacturing firms in Nigeria. This premise ushers in this study which considers all the three dimensions of CSR- environmental, social, and Governance (ESG) to show the effects on firm performance (profitability and cash flows) of each dimension, thus, providing a holistic analysis of firm CSR activities effects on financial performance.

The paper, therefore, establishes two objectives:

1. To examine the effect of environmental, social, and Governance practices on the profitability of quoted manufacturing firms in Nigeria
2. To examine the implications of environmental, social, and Governance practices on cash flows of quoted manufacturing firms in Nigeria

II. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

A. Theoretical Framework

The research work is based on stakeholders' theory and agency theory. Stakeholder theory indicates that the management should have a good relationship with their stakeholders to be a success. More specifically, Carroll and Schwartz (2003) defined 'stakeholder' to include any individual or group who can affect the company's performance or affected by the organization's achievement. The theory has been used extensively in the management literature since 1984. Stakeholder theory demonstrates that firms' benefits from social responsibility come through improved stakeholder relationships. Stakeholder theory gives an option view on corporate Governance and business ethics. Stakeholder theory informs us that managers should consider all the stakeholders' interests when making decisions. Corporate social responsibility (CSR) has been commonly applied because the changing way of the business environment made an interest for firms recognize their obligation to a more extensive voting public than their shareholders/proprietors and take care of basic social issues (Guidry & Patten, 2012).

On the other hand, the agency theory framework proposes that agents (managers) are more likely than principals (stockholders) to emphasize corporate social performance and environmental concerns because they have no remaining case on a firm's income. Agents might show concern for the environment more eagerly because

they are not spending their Cash. Agents are more likely than principals to pursue philanthropic goals to secure their positions, for the case regarding environmental protection practiced by their company. By seeking non-profit goals, managers may enhance their reputation and gain public prestige. Thus, corporate Governance is in accordance with the agency theory basis (Brammer & Pavelin, 2008; Clarkson Li, Richardson & Vasvari, 2011).

B. ESG Accounting and Firm Performance

Environmental, social, and Governance issues are important for stakeholders. According to Carroll (1991) and Wood (1991), any party, including employees, customers, shareholders, the environment, society, and investors, who might be affected by organizations' business activities, should be considered a stakeholder of an organization. According to stakeholder theory, stakeholders can be briefly defined as parties impacting or affected by an organization. ESG measurements aim to capture additional dimensions of corporate performance, which are not revealed in accounting data. Hawking (2006) contended that corporate financial statements cannot inform management and investors about the value of reputation, quality, brand equity, safety, workplace culture, strategies, know-how, and a host of other assets that are more significant than ever in a knowledge-based global economy. Thus, ESG indicators catch a more extensive scope of non-financial data on environmental, social performance, and corporate Governance and can be utilized to evaluate a company's management and support risk management capabilities.

Business success depends on their ability to consider all stakeholders' concerns (Donaldson & Preston, 1995). Stakeholders and their perceptions act as a bridge between businesses' CSR performances and their economic and financial performances (Barnett 2007). Stakeholder theory suggests that all businesses have stakeholders and that they have to fulfill their various obligations towards these stakeholders (Wood 1991). Fisman, Heal & Nair (2006) argued that managers use CSR as a tool to gain competitive advantage and increase market value. Economic performance depends on businesses' ability to take into account all stakeholders' interests reasonably; failing to do so would harm businesses' economic success (Clarkson 1995). Berman, Wicks, Kotha & Jones (1999) stated a relationship between businesses' involvement with stakeholders and economic performance. Hillman and Keim (2001) contended that managing stakeholders effectively could result in increased benefits to shareholders. Stakeholder theory supports the following hypotheses by assuming that the satisfaction of stakeholders' demands for socially responsible activities produces positive economic returns to companies (Richardson 2009).

The environmental dimension of CSR is a highly researched subject. However, the relationship between environmental performance and economic performance remains understudied. Companies that implement environmentally responsible practices are more likely to create positive stakeholder perceptions (Turcotte, M. F.,

Bellefeuille, S., & Hond, F., 2007), resulting in improved economic performance. Although some studies (e.g., Schnietz & Epstien 2005) reported a positive relationship between these two variables, others (e.g., Wagner, M., Van, P. N., Azomahou, T., Wehrmeyer, W., 2002) found a negative relationship.

According to Rhouma, A. B., Francoeur, C., & Robin, G. (2014), stakeholders place a great value on the implementation of various social practices, such as those related to employee rights and training and customer-related issues. There are various advantages of investing in such social practices, in that firms that respond to these stakeholders' needs can enjoy economic advantages (Gao & Bansal 2013). For example, investing in human resource management practices can help businesses reap employee-related benefits (Greening & Turban, 2000). Another economic effect is that social practices can serve as a marketing tool for companies to increase demand for their products and services (Fombrun, 2005). Furthermore, implementing such practices can improve corporate reputation and shareholder satisfaction (Dhaliwal, D., Li, O., Tsang, A. & Yang Y., 2011).

According to Gill (2008), a company's governance practices can shape its stakeholders' perceptions of and behaviors towards the company, which may, in turn, influence its economic performance. There is evidence that managers are willing to invest in CSR activities to increase and maintain their companies' reputations (Barnea & Rubin 2010). Cespa & Cestone (2007) stated that CEOs invest in CSR to increase stakeholder sympathy towards the company, strengthen their positions within the company, and boost economic performance. According to Klettner, A., Clarke, T. & Boersma, M. (2014), corporate Governance affects financial and non-financial outcomes.

The social and Governance dimensions have received relatively scant or no attention in the CSR literature. Regarding the social dimension, a notable study by Cormier, Aerts, Ledoux & Magnan (2009) argues that because social and human capital is key drivers of firm value, objective social practices and disclosures will receive higher valuation by investors. Using a sample of 131 large firms, they find a positive link between social practices and disclosures and firm market value. The literature on the governance dimension shows that through diversification, business groups can reduce transaction costs, risk, and uncertainty in firm operations, thereby lowering default and bankruptcy risks and significantly improving firm value (Chang and Choi, 1988), bridging control-ownership disparity increases efficient firm resources utilization (Shleifer and Vishny, 1997), high ownership concentration and disclosure quality show high firm valuation (as measured in Tobin's Q and stock market returns) (La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny. 2002; Mitton, 2002), an increase of independent directors on the board can improve the firm's compliance with the disclosure requirements, protect the shareholders' interests, maximize shareholders value and result in above-average stock price returns (Ramdani & Witteloostuijn, 2009; Dennis, Dennis & Sarin, 1997; Chen & Jaggi, 2000).

Consistent with prior scholarships and findings, we argue that environmental, social, and Governance practices are value relevant because of a strong reputation in the CSR arena. Higher and more objective environmental, social, and Governance practices and disclosures can help a firm attract and retain quality employees, investors, and customers; enhance employee morale and productivity, build goodwill and trust with its key stakeholders, which helps lower transaction costs and distributional conflicts (by promoting diversity, equality, fair trade terms, board independence, business strategy, etc.) with key stakeholders, and provide competitive advantages for firms in accessing and utilizing the environmental resource. These benefits should have a positive bearing on firms' profitability and cash flows.

From the foregoing, two hypotheses are conjectured:

H1: Environmental, social, and Governance practices have significant effects on the profitability of quoted manufacturing firms in Nigeria

H2: Environmental, social, and Governance practices significantly affect the cash flows of quoted manufacturing firms in Nigeria

C. Empirical Review

Tarmuji, Maelah & Tarjumi (2016) investigated the impact of environmental, social and Governance practices (ESG) on economic performance: evidence from ESG Score, using a sample of non-financial data from two countries (Malaysia and Singapore) for the period of 2010–2014 from ASSET4 database of Data-Stream. Their findings provide empirical evidence that social and Governance practices significantly influence economic performance. The study contributes to the existing literature on ESG practices and their relationship with economic performance utilizing panel data that expand into an international perspective.

Okpa, John, Nkwo & Nyam (2019) examined the implications of environmental, social, and governance dimensions of CSR practice on firms' profitability, value, and cash flows, using non-financial FTSE 100 firms listed in London Stock Exchange from 2007 to 2016. The study finds that, on average, increased total CSR (ESG) practice is positively associated with firm performance. More specifically, environmental and governmental practices positively and significantly affect ROA, share prices, and free Cash flows, respectively. Social practices positively and significantly affect share prices, but negatively and insignificantly affect ROA and FCF. They concluded that overall, high and quality CSR practices improve corporate financial performance.

Miralles, Quiros & Goncalves (2018) examined the value relevance of environmental, social, and governance performance in Brazil between 2010-2015. They found that the market positively and significantly values the environmental practices carried out by companies not related to environmentally sensitive industries. The market positively and significantly values the companies' social and corporate governance practices belonging to these sensitive industries. Their findings are relevant for both investors and the managers of these companies,

policymakers, customers, and citizens concerned about ESG issues.

Atan, Alam, Said & Zamari (2018) investigated the impacts of environmental, social, and governance factors on firm performance: panel study on Malaysian companies. A total of 54 companies are selected from Bloomberg's ESG database with complete ESG and financial data from 2010 to 2013. This study conducted panel data regressions such as the pooled OLS, fixed effect, and random effect. Based on the regression results, they found no significant relationship between individual and combined factors of ESG and firm profitability (i.e., ROE) and firm value (i.e., Tobin's Q). Moreover, individually, none of the factors of ESG is significant with the cost of capital (WACC), but the combined score of ESG positively and significantly influences the cost of capital (WACC) of a company.

III. METHODOLOGY

This study adopts an explanatory non-experimental research design to investigate the relationship between CSR practices and firm financial performance. The study covering ten years between 2009-2018 was collected from eight manufacturing firms quoted in the Nigeria Stock Exchange (NSE). The data collected on variables of ESG include emission reduction, product innovation, and resource consumption reduction (for environmental accounting), product responsibility, community, human rights, diversity and opportunity, employment quality, health and safety, and training and development (for Social accounting), and board functions, board structure, compensation policy, and vision and strategy (for governance accounting).

To test the study hypotheses, Ordinary Least Square Regression Models are specified. For Hypothesis one, Equation (1) and (2) models the association between profitability (ROA) as the dependent variable and CSR

practice measured separately with their sub-constructs. For Hypothesis two, Equations (3) and (4) models, the association between cash flows (CFPS) as the dependent variable and CSR practice measured separately with their sub-constructs. The models are specified thus;

$$ROA_t = \beta_0 + \beta_1ENV_t + \beta_2SOC_{it} + \beta_3GOV_{it} + \varepsilon_{it} \dots\dots (1)$$

$$ROA_t = \beta_0 + \beta_1PM_t + \beta_2RM_t + \beta_3CDP_t + \beta_4ECT_t + \beta_5BC_t + \beta_6LR_t + \varepsilon_t \dots (2)$$

$$CFPS_t = \beta_0 + \beta_1ENV_t + \beta_2SOC_{it} + \beta_3GOV_{it} + \varepsilon_{it} \dots\dots (3)$$

$$CFPS_t = \beta_0 + \beta_1PM_t + \beta_2RM_t + \beta_3CDP_t + \beta_4ECT_t + \beta_5BC_t + \beta_6LR_t + \varepsilon_t \dots (4)$$

Where: ENV denotes environmental performance broken into PM and RM. PM demotes Pollution management performance, and RM denotes resource management performance. SOC denotes social performance, divided into two sub-variables, CDP and ECT. CDP denotes community development and philanthropy performance, ECT denotes employee compensation, and training performance. GOV denotes governance performance, divided into two sub-constructs, BC and LR. BC denotes board performance, LR denotes leadership, and reporting performance. ROA denotes returns on assets, a profitability variable measured as the ratio of earnings before interest and taxes to total assets. CFPS denotes cash flow per share, a cash flow variable measured as operating cash flow divided by the total number of shares.

IV. RESULTS

This section reports the result of panel regression undertaken to test the hypotheses formulated in this study.

A. ESG Dimensions and Firm Profitability

Table 1: Panel Regression Results of Returns on Assets and ESG practices

PANEL A: Panel Regression of Individual ENV, SOC, and GOV impact on ROA				
	Coefficient	Std. Error	t-Statistic	Prob.
C	0.2190	1.313320	13.87251	0.0059
ENV	0.1441***	0.013721	11.214	0.0014
SOC	-0.0422***	0.011228	5.204	0.0481
GOV	0.2181***	0.020845	15.667	0.0000
R-Squared	0.813			
F-Statistics	19.212			
PANEL B: Panel Regression of ESG sub-constructs impact on ROA				
	Coefficient	Std. Error	t-Statistic	Prob.
C	0.1901	1.2647	12.55381	0.0044
PM	0.1370***	0.0096	6.14950	0.0031

RM	0.2070***	1.0379	10.564525	0.0011
CDP	-0.1031***	0.1355	7.79840	0.0221
ECT	0.0902***	0.2341	6.681313	0.0398
BC	0.3218***	1.3824	15.7825	0.0000
LR	0.1522***	1.2110	7.9929	0.0012
R-Squared	0.899			
F-Stats	21.971			

*** denotes significance at 0.05 levels

Panel A of Table 1 shows that Environmental practices (ENV) positively affect returns on assets (ROA), with a positive coefficient of 0.144. This means that a 1 percent increase in Environmental performance increases firms ROA by 14.4 percent. The p-value of 0.0011, less than 0.05 level of significance, indicates that the effect is statistically significant.

Social practices (SOC) negatively affect ROA, with a negative coefficient of 0.042. Stated differently, a 1 percent increase in Social practices decrease firms ROA by 4.2 percent. The p-value of 0.0481, less than 0.05 level of significance, indicates that the negative effect is statistically significant.

Governance practices have a positive impact on ROA, with a coefficient of 0.2181. This means that as corporate Governance increases by 1 percent, ROA simultaneously increases by 21.8 percent. The p-value of 0.000 less than the 0.05 level of significance indicates that the positive effect is statistically significant.

The R squared is 0.813, which shows that the variables significantly explain about 81.3 percent of ROA variation. The F-statistics of 19.21 (p=0.0000) means that the dimensions of ESG have a significant effect on ROA.

Panel B of Table 2 shows the effect of practices in each ESG variable on ROA. Pollution management (PM) leads to a positive and significant effect on ROA, with a coefficient of 0.137 (p=0.0031), indicating a 13.7 percent significant effect on ROA. Resource management (RM) leads to a positive and significant effect on ROA, with a coefficient of 0.207 (P=0.0011), indicating a 20.7 percent significant effect on ROA.

Community Development and Philanthropy (CDP) leads to a negative and significant effect on ROA, with a coefficient of 0.103 (p=0.0221), indicating a 10.3 percent significant effect on ROA. Employee compensation and training (RM) leads to a positive and significant effect on ROA, with a coefficient of 0.090 (P=0.0398), indicating a 9 percent significant ROA effect.

Board composition (BC) leads to a positive and significant effect on ROA, with a coefficient of 0.322 (p=0.0000), indicating a 32.2 percent significant effect on ROA. Leadership and reporting (LR) lead to a positive and significant effect on ROA, with a coefficient of 0.152 (P=0.0012), indicating a 15.2 percent significant effect on ROA.

The R squared is 0.899, which shows that the variables significantly explain about 90 percent of ROA variation. The F-statistics of 21.97 (p=0.0000) means that the activities of the dimensions of ESG have a significant effect on ROA.

Hypothesis 1 Decision: Panel A shows that environmental practices and governance practices individually have a statistically significant impact on ROA. Panel B also revealed that pollution management, resource management, community development and philanthropy, employee compensation and training, board performance, and leadership/reporting all significantly affect ROA. The results support the acceptance of H1. Thus, environmental, social, and Governance practices have significant effects on the profitability of quoted manufacturing firms in Nigeria.

B. ESG Dimensions and Firm Cash Flows

Table 2. Panel Regression Results of Free Cash Flow, individual and combined ESG practices, and control vectors.

PANEL A: Panel Regression of Individual ENV, SOC, and GOV impact on Cash Flow				
	Coefficient	Std. Error	t-Statistic	Prob.
C	11.117	231.0540	16.40792	0.0000
ENV	5.0932***	1.648806	3.089066	0.0021
SOC	10.3653***	1.577307	-0.231641	0.0081
GOV	15.103***	2.961973	5.099046	0.0000
R-Squared	0.912			
F-Statistics	11.874			
PANEL B: Panel Regression of ESG sub-variables impact on Cash Flow				
	Coefficient	Std. Error	t-Statistic	Prob.
C	6.2050	177.9340	-19.44657	0.0328
PM	10.8121***	1.737834	6.222027	0.0211
RM	14.8684***	2.071644	-2.350038	0.0190
CDP	2.2896***	23.61469	17.45903	0.0449

ECT	10.0634***	0.031503	2.012794	0.0445
BC	24.6288***	1.995356	-2.319726	0.0000
LR	17.8851***	25.41304	14.94843	0.0206
R-Squared	0.965			
F-Statistics	17.129			

*** denotes significance at 0.05 levels

Panel A of Table 2 shows that Environmental practices (ENV) positively affect cash flows (CFPS), with a positive coefficient of 5.09. This means that a 1 percent increase in Environmental performance increases firms CFPS by 5.09 kobo. The p-value of 0.0021, less than 0.05 level of significance, indicates that the effect is statistically significant.

Social practices (SOC) positively affect CFPS, with a positive coefficient of 10.36. Stated differently, a 1 percent increase in Social practices decrease firms CFPS by 10.4 kobo. The p-value of 0.0081, less than 0.05 level of significance, indicates that the positive effect is statistically significant.

Governance practices have a positive impact on CFPS, with a coefficient of 15.10. This means that as corporate Governance increases by 1 percent, CFPS increases by 15.10 kobo. The p-value of 0.000 less than the 0.05 level of significance indicates that the positive effect is statistically significant.

The R squared is 0.912, which shows that the variables significantly explain about 91.2 percent of the variation in CFPS. The F-statistics of 11.87 (p=0.0000) means that the dimensions of ESG have a significant effect on CFPS.

Panel B of Table 2 shows the effect of practices in each ESG variable on CFPS. Pollution management (PM) leads to a positive and significant effect on CFPS, with a coefficient of 10.81 (p=0.0211), indicating a 10.8 kobo significant effect on CFPS. Resource management (RM) leads to a positive and significant effect on CFPS, with a coefficient of 14.86 (P=0.0190), indicating a 14.9 kobo significant effect on CFPS.

Community Development and Philanthropy (CDP) leads to a negative and significant effect on CFPS, with a coefficient of 2.29 (p=0.0449), indicating a 2.29 kobo significant effect on CFPS. Employee compensation and training (RM) leads to a positive and significant effect on CFPS, with a coefficient of 10.06 (P=0.0445), indicating a 10.1 kobo significant effect on CFPS.

Board performance (BC) leads to a positive and significant effect on CFPS, with a coefficient of 24.63 (p=0.0000), indicating a 24.6 kobo significant effect on CFPS. Leadership and reporting (LR) lead to a positive and significant effect on CFPS, with a coefficient of 17.89 (P=0.0206), indicating a 17.9 kobo significant effect on CFPS.

The R squared is 0.965, which shows that the variables significantly explain about 97 percent of the variation in CFPS. The F-statistics of 17.13 (p=0.0000) means that the activities of the dimensions of ESG have a significant effect on CFPS

Hypothesis 2 Decision: Panel A shows that environmental practices and governance practices individually have a statistically significant impact on CFPS. Panel B also revealed that pollution management, resource management, community development and philanthropy, employee compensation and training, board performance, and leadership/reporting all significantly affect CFPS. The results support the acceptance of H2. Thus, environmental, social, and Governance practices significantly affect the cash flows of quoted manufacturing firms in Nigeria. This result is consistent with Richardson and Welker's findings (2001) and Gutsche (2017).

V. CONCLUSION

The paper analyzed the firm's performance effects of ESG practices, measured in three dimensions: environmental, social, and Governance, for eight manufacturing firms for the fiscal years 2009 to 2018. The study found that higher CSR practices result in higher profitability, measured by Return on Assets (ROA), and higher cash flows, measured by cash flows per share (FCF). Specifically, the paper found that while environmental and Governance practices result in higher profits, social practices lower profitability. While the social dimension, community development, and philanthropy reduce ROA, employee compensation and training improves ROA. The results show that higher and increased investment in environmental, social, and Governance initiatives confer on the expending or practicing firm the benefit of reaping higher performance in terms of cash flows per share. The findings are relevant to equity analysts and fund managers in making stock decisions relevant to manufacturing firms' managers in making value-adding investments.

Therefore, it is recommended that managers of manufacturing firms invest in higher environmental, social and Governance performance to reap higher profitability and cash flow performance.

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