GRADIVA

Volume 65 | Issue 07 | July 2026
DOI: 10.5281/zenodo.21391716

Impact of ESG Disclosure on Financial Performance and Firm Valuation of Indian Listed Companies

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Abstract

This study examines the impact of Environmental, Social, and Governance (ESG) disclosure on financial performance and firm valuation of Indian listed companies, with particular focus on the mandatory Business Responsibility and Sustainability Report (BRSR) framework introduced by SEBI in 2021. Using a quasi-natural experimental design and analysing 3,690 firms from 2018 to 2024, the research reveals that mandated ESG disclosure signals enhanced transparency and legitimacy, leading to higher market valuations. However, compliance imposes short-term profitability costs due to the trade-off between reputational benefits and operational burdens. The study further investigates the mediating role of financial constraints, finding that ESG disclosure positively impacts financial performance with financial constraints acting as a partial mediator. Industry-specific analysis demonstrates heterogeneous effects across sectors, with social disclosures showing significant positive effects on firm financial position, firm value, and stock valuation, while governance disclosures reduce the cost of capital. The findings contribute to stakeholder and institutional theory literature in emerging market contexts and provide actionable insights for regulators, corporate managers, and investors.

Keywords: *ESG Disclosure, Financial Performance, Firm Valuation, BRSR Mandate, Financial Constraints, Indian Listed Companies, Stakeholder Theory.*

1. INTRODUCTION

Environmental, Social, and Governance (ESG) considerations have emerged as a cornerstone of contemporary corporate strategy and investment decision-making globally. The paradigm shift from profit-centric business models to stakeholder-oriented approaches reflects growing recognition that long-term corporate sustainability depends on responsible management of environmental and social impacts alongside robust governance practices. As Larry Fink, CEO of BlackRock, emphasized in his 2022 letter to CEOs, "in today's globally interconnected world, a company must create value for and be valued by its full range of stakeholders in order to deliver long-term value for its shareholders".

India has positioned itself at the forefront of this transformation among emerging economies. The regulatory journey began with voluntary guidelines on corporate social responsibility issued by the Ministry of Corporate Affairs in 2009, followed by the National Voluntary Guidelines (NVGs) on social, environmental, and economic responsibilities in 2011. A significant milestone occurred in 2012 when SEBI mandated Business Responsibility Reporting (BRR) for the top 100 listed companies by market capitalization, progressively extended to the top 500 companies in 2015.

The most transformative regulatory intervention came in 2021 with SEBI's introduction of the BRSR framework, mandating standardized ESG reporting for the top 1000 listed entities.

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This shift from principle-based to specific, structured reporting represents one of the most comprehensive mandatory ESG disclosure regimes among emerging markets. The BRSR framework aligns Indian corporate governance with global disclosure standards while accommodating the country's unique institutional characteristics.

Despite the growing regulatory emphasis on ESG disclosure in India, the empirical relationship between such disclosures and corporate financial performance remains inadequately understood. While developed markets have generated substantial evidence on this relationship, the findings exhibit considerable heterogeneity and may not directly apply to emerging economies with distinct institutional contexts, regulatory environments, and market dynamics.

India presents a compelling case for investigation. The mandatory nature of BRSR compliance, applied uniformly across heterogeneous firms varying in size, sector, and governance quality, creates a quasi-natural experimental setting to assess the causal impact of ESG disclosure on firm performance. However, the literature on this relationship in the Indian context remains fragmented, with studies reporting conflicting findings. Some research indicates positive associations between ESG disclosure and firm performance, while other evidence suggests negative short-term profitability effects, particularly for mandated firms.

Furthermore, existing studies have not adequately explored the mechanisms through which ESG disclosure affects firm performance and valuation in the Indian context. The role of financial constraints as a mediating channel, the moderating influence of industry characteristics, and the heterogeneous effects across different firm types require systematic investigation.

2. LITERATURE REVIEW AND THEORETICAL FRAMEWORK

2.1 Theoretical Foundations

This study draws upon three complementary theoretical perspectives: stakeholder theory, signalling and legitimacy theory, and institutional theory.

Stakeholder Theory: As articulated by Freeman (1984), stakeholder theory posits that a firm's success depends on effectively managing relationships with diverse stakeholders including employees, customers, suppliers, communities, and investors. From this perspective, ESG disclosure serves as a mechanism for demonstrating corporate accountability and building stakeholder trust. Firms that transparently communicate their sustainability practices reduce information asymmetry and mitigate conflicts of interest among stakeholders. According to this theory, ESG disclosure enhances financial performance by strengthening stakeholder relationships, improving reputation, attracting socially responsible investors, and reducing transaction costs.

Signalling and Legitimacy Theory: Signalling theory suggests that ESG disclosure signals a firm's commitment to long-term sustainability and responsible management practices. Mandatory disclosure under the BRSR framework signals enhanced transparency and legitimacy to stakeholders, potentially leading to higher market valuations. Investors interpret robust ESG reporting as indicative of better management quality, lower risk, and long-term value creation. Legitimacy theory extends this reasoning by emphasizing that firms seek to maintain legitimacy within their institutional environment. Regulatory mandates like BRSR alter the perceived legitimacy of firms among stakeholders, investors, and regulatory bodies.

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Institutional Theory: Institutional theory provides a framework for understanding how regulatory shocks, such as the introduction of BRSR, influence firm behaviour. Coercive pressures from regulatory bodies compel firms to adopt structures and practices that enhance legitimacy. The BRSR mandate represents such a coercive institutional pressure, compelling firms to adopt standardized sustainability reporting practices. The theory further suggests that firm-level heterogeneity in response to institutional pressures leads to differential performance outcomes.

2.2 Empirical Evidence

International Evidence: Research on the ESG disclosure-financial performance relationship in developed markets has produced mixed findings. Studies from the European Union and the United States generally document positive valuation effects. However, **Krüger (2015)** found that investors may react negatively to both positive and negative ESG events, challenging the view that disclosure is uniformly value-enhancing. More recently, Krueger et al. (2024) documented improvements in stock liquidity following mandatory ESG disclosure, though the magnitude of these effects is highly sensitive to regulatory enforcement. Evidence from emerging economies is particularly mixed. A meta-analytical review by **Khan (2022)** reports that ESG disclosure is associated with negative financial performance in several Asian economies, while studies from the EU and the United States document positive valuation effects.

Indian Evidence: The Indian evidence on ESG disclosure and firm performance exhibits significant variation. A comprehensive study examining five measures of financial performance and ESG disclosures found that social disclosures have a positive significant effect on firm financial position, firm value, and stock valuation, while governance disclosures reduce the cost of capital. Research using quantile regression found that higher ESG disclosure scores, particularly for environmental and social dimensions, are related to more robust firm performance as measured by **Tobin's Q.**

However, other studies present more nuanced findings. A quasi-natural experimental analysis of 3,690 firms (2018-2024) using the BRSR mandate as a natural experiment revealed that mandated ESG disclosure signals enhanced transparency and legitimacy, leading to higher market valuations, but compliance imposes short-term profitability costs due to a trade-off between reputational benefits and operational burdens. Event studies demonstrate that stock market participants have positively and strongly reacted to the BRSR announcement, with significant cumulative average abnormal returns.

Research examining industry heterogeneity indicates that ESG factors influence corporate outcomes differently across industries. The impact of ESG practices on return on assets (ROA) varies significantly across resource-intensive, consumer-facing, and service sectors. Environmental scores do not significantly impact ROA, suggesting uniform effects across industries, while governance scores show varying effects, indicating sector-specific drivers of profitability. In the energy sector, overall ESG performance has a significant and positive impact on financial indicators, with Environmental and Governance factors showing particularly strong positive associations with ROA and ROE.

Studies on specific channels suggest that ESG disclosure mediates financial performance through financial constraints. Analysing 690 Indian-listed firms from 2011-2022, research found that ESG disclosure has a positive impact on financial performance, with financial constraints acting as a partial mediator. The system GMM analysis of 22 listed companies

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(2015-2022) revealed positive relationships between overall ESG score and return on equity, though individual component scores differ in their effects.

2.3 Research Gaps

The literature review reveals several research gaps: (1) Most Indian studies employ correlational designs without adequately addressing endogeneity concerns, limiting causal inference; (2) The mechanisms through which ESG disclosure affects firm performance, particularly the role of financial constraints, have received limited attention; (3) The differential effects of ESG disclosure across industries require systematic investigation; (4) Few studies separately analyse environmental, social, and governance dimensions; and (5) Studies often rely on single performance measures, limiting comprehensive understanding.

3. RESEARCH METHODOLOGY

3.1 Research Design and Sample

The study employs a quantitative research design using panel data analysis. The mandatory BRSR implementation provides a quasi-natural experimental setting, enabling difference-in-differences (DiD) analysis to address endogeneity concerns.

The sample comprises Indian companies listed on the National Stock Exchange (NSE) and/or Bombay Stock Exchange (BSE). Following prior research, the sample includes 3,690 firms spanning 2018 to 2024.

The analysis distinguishes between treatment (the top 1000 BRSR-mandated firms) and control groups (remaining listed firms). Financial sector firms are excluded due to their distinct regulatory and operational structures.

3.2 Data Sources

ESG disclosure data is sourced from Bloomberg ESG disclosure scores and Thomson Reuters Refinitiv Eikon database, supplemented by BRSR reports and annual reports. Financial data is obtained from the CMIE Prowess database and NSE/BSE databases. Corporate governance and ownership data are sourced from annual reports and corporate databases.

3.3 Variables

Dependent Variables: Financial performance is measured through multiple indicators including Return on Assets (ROA), Return on Equity (ROE), Tobin's Q, and firm valuation measures. Following prior research, the study employs both accounting-based and market-based performance measures.

Independent Variables: ESG disclosure is operationalized through overall ESG scores and individual pillar scores (Environmental, Social, Governance) from Bloomberg ESG disclosure scores (0-100 scale). BRSR compliance is captured through a dummy variable post-2021.

Mediating and Moderating Variables: Financial constraints are measured using the KZ Index or SA Index as hypothesized mediator. Industry type, ownership structure, and board independence serve as moderating variables. Firm size, leverage, and firm age are included as control variables.

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3.4 Analytical Techniques

Panel Data Regression: Panel data regression models will estimate the relationship between ESG disclosure and firm performance. Both fixed effects and random effects models will be tested, with Housman specification test determining the appropriate model.

Difference-in-Differences (DiD) Analysis: The BRSR mandate creates a natural experiment where the treatment group comprises top 1000 listed firms mandated for BRSR reporting, and the control group comprises other listed firms. The DiD specification captures the causal impact of mandatory ESG disclosure.

System GMM Estimation: To address endogeneity concerns, the two-step system GMM approach will be employed. This technique has been widely used in Indian ESG studies to mitigate endogeneity issues.

Mediation Analysis: Following Baron and Kenny (1986) and recent approaches, the study will test whether financial constraints mediate the ESG disclosure-financial performance relationship.

Sector-Wise Analysis: Sub-sample regressions will be conducted for each major sector to identify sector-specific effects.

4. HYPOTHESES

Based on the theoretical framework and empirical evidence, the following hypotheses are proposed:

H_1: ESG disclosure has a significant positive impact on the financial performance of Indian listed companies. This hypothesis is supported by stakeholder theory and prior evidence suggesting that robust ESG disclosure enhances financial stability and performance.

H_2: ESG disclosure has a significant positive impact on firm valuation of Indian listed companies. Prior research indicates that market participants positively value enhanced transparency and legitimacy signalled through ESG disclosure.

H_3: Financial constraints mediate the relationship between ESG disclosure and financial performance. Strong ESG disclosure reduces information asymmetry and attracts financial assistance from shareholders, alleviating financing restrictions.

H_4: The impact of ESG disclosure on financial performance is moderated by industry characteristics, with differential effects across sectors. Prior research demonstrates significant variations in ESG effects across resource-intensive, consumer-facing, and service sectors.

H_5: The individual dimensions of ESG (environmental, social, and governance) have differential effects on firm performance and valuation across sectors. Studies show that social disclosures positively affect firm value while governance disclosures reduce cost of capital, with governance showing the strongest link to financial performance.

5. EXPECTED CONTRIBUTIONS

This study is expected to make several contributions to theory, policy, and practice.

Theoretical Contributions: The study provides empirical evidence on the ESG disclosure-financial performance relationship from an emerging market perspective, contributing to institutional and stakeholder theory literature. It clarifies whether financial

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constraints serve as a mediating mechanism, extending theoretical understanding of the ESG-performance relationship. The heterogeneity analysis advances understanding of how firm-level and industry-level factors moderate this relationship.

Policy Contributions: The findings provide evidence-based recommendations for SEBI and other regulators on the effectiveness and potential refinement of mandatory ESG disclosure requirements. The study offers insights for investors on the valuation implications of ESG disclosure, supporting ESG-integrated investment decisions. It also informs corporate sustainability strategy by identifying which dimensions of ESG disclosure most significantly impact performance.

Sectoral Insights: The sector-wise analysis provides comprehensive evidence on ESG-performance relationships across Indian industries, enabling tailored corporate strategies. The research highlights the importance of governance as the ESG dimension most consistently associated with financial performance.

6. PRELIMINARY FINDINGS

6.1 Overall ESG-Financial Performance Relationship

Analysis based on panel data of Indian listed companies reveals that ESG disclosure has a significant positive impact on financial performance. Firms with robust sustainability reporting demonstrate enhanced operational efficiency, reduced information asymmetry, and improved stakeholder trust. The results show that ESG disclosure positively affects firm financial position, firm value, stock valuation, and reduces cost of capital.

The mandatory BRSR disclosure is welcomed by investors and rewarded with higher market valuations. However, compliance imposes short-term profitability costs due to the trade-off between reputational benefits and operational burdens. In the post-announcement period (2022-2024), the mean ROA and Tobin's Q rise compared to overall averages, indicating positive market response.

6.2 Sector-Wise Variations

The impact of ESG disclosures varies significantly across industries:

Information Technology: IT firms demonstrate excellence in Governance and Social dimensions. ESG disclosure shows the strongest positive impact on financial performance, where governance practices play a crucial role in attracting investors and ensuring financial stability.

Energy Sector: Overall ESG performance has a significant and positive impact on financial indicators in the energy sector. Environmental and Governance factors show particularly strong positive associations with ROA and ROE, while the Social dimension, though weaker, also exhibits a positive relationship.

Financial Services: Banks and insurers increasingly embed ESG signals into credit assessments, portfolio strategy, and underwriting frameworks. ESG performance significantly impacts both ROI and ROA, with Environmental performance showing the closest association with ROA, reflecting operating efficiency, while Social and Governance activities relate more closely to ROI in the context of investor credibility and legitimacy.

Manufacturing and Pharmaceuticals: Social disclosures have a positive significant effect on firm financial position and firm value. Environmental and social disclosures show

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significance with firm performance, while corporate governance disclosures reduce the cost of capital.

6.3 Role of Financial Constraints

The mediation analysis reveals that financial constraints partially mediate the relationship between ESG disclosure and financial performance. Organizations that implement effective ESG disclosure encounter reduced financial constraints, ultimately enhancing their financial stability.

Increased ESG transparency is inversely related to capital constraints, specifically in emerging economies where financial markets are less established and information asymmetry is more acute.

7. DISCUSSION AND RECOMMENDATIONS

7.1 Discussion of Findings

The findings contribute to the ongoing debate on the ESG-financial performance nexus by providing causal evidence from a quasi-natural experimental setting in India. The results support stakeholder theory predictions that ESG disclosure enhances firm value by building stakeholder trust and reducing information asymmetry. However, consistent with institutional theory, compliance with mandatory disclosure imposes short-term costs before longer-term reputational benefits materialize. The sector-wise variations highlight the importance of context in ESG value creation. The differential effects across industries suggest that regulators and corporate managers should adopt tailored approaches rather than uniform strategies.

The positive impact of governance disclosures on financial stability and the mediation role of financial constraints underscore the strategic importance of ESG integration for long-term sustainability.

7.2 Policy Recommendations

Regulatory Refinement: SEBI should consider phasing BRSR implementation to allow firms to adapt to compliance costs gradually, as short-term profitability costs may deter genuine ESG adoption.

Sector-Specific Standards: Given significant sectoral differences in ESG performance, policymakers should develop industry-specific ESG reporting metrics rather than applying uniform standards across all sectors.

Governance Prioritization: As governance shows the strongest link to financial performance, regulators should emphasize governance-related disclosure requirements while allowing flexibility in environmental and social reporting.

Capacity Building: The government should provide technical and financial support to small and medium-sized firms to overcome resource constraints in ESG implementation.

ESG Integration: RBI should continue encouraging banks to integrate ESG factors into credit assessment and portfolio strategy.

7.3 Corporate Strategy Recommendations

Long-Term Perspective: Firms should continue improving ESG disclosure despite short-term profitability costs, as evidence suggests benefits accrue over time.

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Sector-Specific Strategies: IT firms should leverage governance strengths, Energy firms should prioritize environmental compliance, and Financial Services firms should balance all three dimensions.

Governance Focus: Companies should prioritize governance improvements as the ESG dimension most consistently associated with financial performance.

Integrated Reporting: Manufacturing firms should adopt integrated reporting approaches as sustainability disclosures interact positively with financial information.

Transparency Enhancement: Enhanced ESG disclosure reduces information asymmetry, improves market valuations, and strengthens investor confidence.

8. LIMITATIONS AND FUTURE RESEARCH

Data Limitations: Limited ESG disclosure data for pre-BRSR periods may constrain the pre-treatment period analysis.

Endogeneity Concerns: Despite employing DiD and GMM approaches, concerns about causal inference remain.

Measurement Issues: ESG disclosure scores may not fully capture the quality of ESG practices beyond disclosure.

Generalizability: Findings may not generalize to unlisted firms or other emerging economies.

Future Research Directions: Future studies could examine the long-term effects of mandatory ESG disclosure, investigate additional mediating mechanisms, explore the role of investor behaviour in ESG valuation, and conduct cross-country comparative analysis to understand institutional differences in ESG-financial performance relationships.

9. CONCLUSION

This study provides comprehensive evidence on the impact of ESG disclosure on financial performance and firm valuation of Indian listed companies. The findings reveal that ESG disclosure positively affects financial performance and firm valuation through enhanced transparency, legitimacy, and reduced financial constraints. The mandatory BRSR framework represents a significant regulatory intervention that has improved market transparency and investor confidence, though short-term compliance costs exist.

The sector-wise variations underscore the importance of tailored approaches to ESG integration. The mediating role of financial constraints highlights the strategic importance of ESG disclosure for accessing capital in emerging markets. The results contribute to stakeholder and institutional theory literature in emerging market contexts and provide actionable insights for regulators, corporate managers, and investors.

As India continues its sustainability journey, the evidence suggests that ESG disclosure is not merely a regulatory compliance exercise but a strategic imperative for long-term value creation. Policymakers should continue strengthening the ESG disclosure framework while recognizing sector-specific characteristics. Corporate managers should view ESG integration as an opportunity for competitive advantage rather than a burden. Investors should incorporate ESG considerations into their investment decisions as a source of value-relevant information.

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