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Building a model to study the impact of ESG on business performance at small and medium enterprises

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Abstract
ESG (Environmental - Social - Governance) is a set of standards on the environment, society and corporate governance in the process of firm operations. In the development of the current socio-economic situation, the community increasingly understands the necessity of sustainable development for the economy in general and each firm in particular. ESG plays an important role in helping stakeholders understand how firms manage risks, as well as opportunities for sustainable development for firms. Capital investors are more interested in creating sustainable investments as a result of the current surge in interest in sustainability challenges brought on by climate change. Furthermore, stakeholders, regulators, and the general public are becoming more interested in finding out more about the benefits of sustainability reporting on corporate outcomes. From the standpoint of an investor, it is interesting to think about if this investment might have a good effect on a firm's financial success because sustainable investments are usually accompanied with high costs. This study developed a theoretical model based on the theories of risk management and stakeholder theory, where the independent variable is ESG and the dependent variable is business performance. This paper presents the theoretical model through a review of existing literature and related studies and provides a more specific direction for the ensuing empirical analysis. Researching the influence of ESG on the business performance of SMEs has many practical implications and contributes to perfecting the theoretical framework for business performance in Vietnam today.

Keywords: ESG (Environmental, Social, Governance), Business Performance, Economics, Business Administration, Small and Medium Enterprises (SMEs)

JEL codes: M10, A14, M10, O15

1. Introduction

Business performance is one of the topics that always receives the attention of academic researchers and enterprise managers. Especially in the current business context with many complex developments in the world, the entire society is implementing digital transformation, and businesses are applying digital technology and the achievements of the 4.0 industrial revolution.

In the context of severe climate change leaving many consequences and huge losses for the whole society, aiming to develop a sustainable society is the top priority of each country on all three pillars: economy, society and environment. SMEs are the backbone of the Vietnamese economy, accounting for about 98% of the total number of enterprises and contributing significantly to GDP. SMEs play an important role in the economy, especially in creating jobs and allocating human resources. Therefore, sustainable development of SMEs has been, is and will be an inevitable development trend, not only of interest in Vietnam but also of attention worldwide.

It can also be stated that SMEs, as part of entrepreneurship, have the potential to support the country's economy, both in quantity and quality, as shown by business owners (Parmitasari & Rusnawati, 2023) [14]. Besides, recently, SMEs in Vietnam have had remarkable development, especially in the fields of technology, services, and export.

In fact, ESG areas in SMEs in Vietnam have not been fully, accurately and closely implemented. Many previous studies have not provided sufficient information on the areas that ESG targets, namely economy, environment and society, but only focus on the environmental aspect.

Research on the impact of ESG on the performance of small and medium-sized enterprises has many practical implications and contributes to perfecting the theoretical framework on ESG and the performance of small and medium-sized enterprises in Vietnam today.

2. Literature Review

2.1 Risk Management Theory

Risk management theory (Godfrey, 2005) [7] suggests that even in times of crisis, a firm's corporate social performance (CSP) can create positive moral capital among various stakeholders that can provide insurance-like protection for the firm. Godfrey (2005) [7] stated that this moral capital is created by the positive evaluation of a firm's CSP from stakeholders due to their perception of the firm's positive contributions, and this positively influences the attitudes and loyalty of customers and partners as well as employees (Luo & Bhattacharya, 2009) [12]. This will reduce the sanctions of stakeholders against the enterprise in the event of a crisis, making future cash flows less volatile, and thus reducing risks (Chang *et al*., 2014) [3]. In this context, the involvement of corporate social responsibility (CSR), corresponding to moral capital, creates a mechanism to maintain economic value. Godfrey *et al*. (2009) [8] proposed and reinforced this theory with empirical studies, which showed that the loss of shareholder value in the context of a negative event is smaller for firms that engage in CSR activities.

2.2 Stakeholder Theory

Stakeholder theory is often used to explain the positive impact of CSP on firm value. It states that the needs of stakeholders, not just shareholders, must be integrated into corporate governance because meeting the needs of these stakeholders directly creates value for shareholders (Freeman, 2010) [6]. Based on stakeholder theory, it can be argued that high levels of CSP are associated with lower financial risk. While low levels of CSP make firms more likely to face litigation and legal penalties, high levels of CSP can promote more stable relationships with the government and the financial community. Furthermore, market participants are willing to allocate more capital to firms with higher levels of CSP, so good CSR practices can increase investment attractiveness (Cheng *et al*., 2014) [4]. Better CSP can enhance reputation, enhance brand value, and improve product image in the minds of consumers. In addition, CSR can increase a firm's attractiveness as an employer and help attract and retain a high-quality workforce (Greening & Turban, 2000) [9]. A firm with a good CSP score can also be seen as a signal of superior management skills. Overall, these research findings suggest that better CSP leads to a firm's lower exposure to financial risk and, therefore, lower stock market risk and lower likelihood of a crisis (Oikonomou *et al*., 2012) [13].

2.3 ESG

Environment

The environmental pillar assesses a company's environmental efforts, such as its attempts to control pollution and waste produced during production, reduce carbon emissions and mitigate climate change, use energy efficiently, and pay attention to biodiversity and deforestation.

Social

The social pillar summarizes a company's perspective on individuals and relationships. Included are community relations, employee involvement, gender and diversity considerations, maintaining data privacy and security, customer happiness, human rights, and labor standards.

Governance

The governance pillar talks about rules for running a company. It covers executive compensation, lobbying, political contributions, bribery and corruption prevention, board composition, audit committee structure, and whistleblower programs.

ESG Benefits

ESG has become one of the most significant indicators of managerial ability, risk management, and non-financial performance, and it may help investors by assisting in decision-making for long-term investment performance (Abdul Halim, 2014) [1]. In addition to measures to optimize their positive influence on the environment and society, ESG may help firms uncover hidden or potential issues. According to Ting *et al*. (2019) [18], the ESG score can be used to first assess how a business is managing sustainability issues strategically. Second, there is a close connection between ESG and SRI, a popular investing approach that provides investors with more information. Third, ESG provides investors with valuable information on a company's sustainability, corporate governance, environmental impact, and corporate social responsibility.

2.4 Business performance

According to Lin and Kuo (2007) [11], business performance is a measure of how successfully an organization achieves its objectives. New or improved attempts to create growth and profitability lead to business performance, which is the total accomplishments of the company (Gunday *et al*., 2011) [10].

Perlin *et al*. (2022) [15] conducted an e-survey with 39 industrial companies in Brazil that was exploratory and descriptive with a qualitative and quantitative stage. The findings demonstrate the connections that have been found between mitigation strategies and various aspects of company performance, particularly with regard to innovation.

According to Yaskun *et al*. (2023) [21], a competitive edge will improve MSMEs' business performance by boosting sales, earnings, and client base.

Using random sampling, Widodo (2023) [20] employed verification techniques on a sample of 200 respondents. Lisrel was used to evaluate the data using structural equation models (SEM). The findings indicate that knowledge management and entrepreneurial orientation significantly impact SMEs' business performance and competitive advantage, and that the relationship between these two factors and SMEs' business performance in West Java can act as a mediator of competitive advantage.

2.5 ESG and business performance

When considering ESG issues in investing, investors often consider non-financial indicators based on theories from two other related fields, namely corporate social responsibility (CSR) and socially responsible investing (SRI). CSR theory explains why businesses pursue non-financial goals, and the field of SRI considers investing in companies with high

CSR performance indicators. The widely accepted definition of SRI is an investment style that combines financial goals with social and environmental goals (Sparkes, 2001) [17].

Stakeholder theory provides a foundation for understanding a firm's CSR relationships. From a stakeholder perspective, firms engage in CSR to meet the needs of various stakeholders (Varenova *et al*., 2013) [19], which will lead to improved financial performance (Endrikat *et al*., 2014) [5].

When considering investment decisions, in addition to financial activities, non-financial activities related to corporate social responsibility (CSR) are increasingly attracting the attention and interest of not only investors but also stakeholders. Corporate social performance (CSP) is often operated and evaluated by factors called ESG factors (Gramlich & Finster, 2013). It is assumed that when a firm has high CSP, it has the potential to increase the value of that firm by increasing its corporate financial performance (CFP), such as reducing the cost of capital (Plumlee *et al*., 2015) [16]. Therefore, if corporate risk is considered an important determinant of capital price, then CSP has an impact on shareholder value if it affects corporate risk (Bouslah *et al*., 2013) [2].

Based on the research results of Freeman (1984), the Stakeholders Theory states that organizations have an obligation to treat stakeholders fairly, including internal and external stakeholders. This has a direct impact on the organization's performance and business results. ESG information disclosure is made publicly and clearly in the annual reports of SMEs to ensure maximum access to stakeholders to ensure their legitimate rights and interests. Pursuing ESG goals is a long journey in which SMEs must sacrifice the profits they create to achieve a longer-term goal. If SMEs accept to implement sustainable development, profit maximization will no longer be the main goal. Therefore, SMEs need to pay more attention to stakeholders to accurately orient a specific goal for their own business as well as stakeholders.

3. Research method

This study used qualitative research methods.

The literature search included works published from 2000 to the present.

A total of 21 sources were reviewed, abstracted, and analyzed to facilitate this review. The studies that were reviewed were chosen using the following criteria: (i) Those addressing the resources that can help us learn more about ESG and business performance. (ii) Research focusing on the importance of ESG and business performance.

We also conducted interviews with leading experts in ESG and business performance. They are board of directors or chairman of the board or business managers of SMEs and senior lecturers with practical experience working for leading universities in Vietnam.

This study developed a theoretical model based on the theories of risk management theory and stakeholder theory, where the independent variable is ESG and the dependent variable is business performance. This paper presents the theoretical model through a review of existing literature and related studies and provides a more specific direction for the ensuing empirical analysis.

4. Proposed a research model

Inheriting the conclusions of previous studies and based on the opinions of interviewed experts, we propose a research model (see Fig 1).

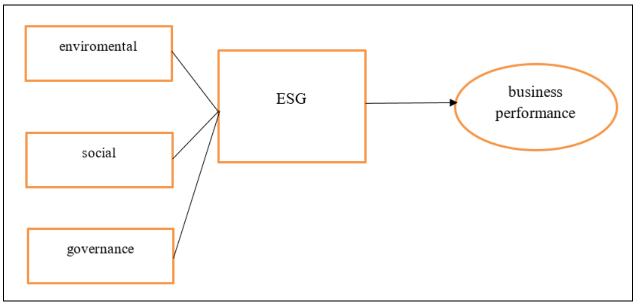

Fig1: Research model

5. Discussion and implications

For small and medium-sized businesses, human resources are crucial. Therefore, through the amount and caliber of their yearly training, SMEs should raise the caliber of their human resources. SMEs should create training programs that foster creativity and learning capabilities while expanding the range of employee competencies, particularly in the areas of digital transformation and the implementation of technological revolution 4.0 advancements. Small and medium-sized businesses should also have plans in place for training facility orders and human resource development. When creating and overseeing training programs, companies, colleges, and training specialists should work closely together. Small and medium-sized businesses should also create suitable and efficient employee welfare, bonus, and compensation plans.

Small and medium-sized businesses should raise the standard of science and technology at every level, from team structure to production, from product technology to distribution and consumption. Put your attention on using technological and scientific advancements in company and production. Establish and choose the technological development orientation, goals, and strategies, as well as the enterprise's clear place in the value chain. In order to enhance management abilities and technological proficiency, companies must also encourage specialization and aggressively engage in global supply chains.

Stakeholders, investor regulators, and citizens have become increasingly aware of the value of ESG practices for society in recent years, but more work is required to raise awareness of the benefits of ESG practices for business success. Many performance factors can be impacted by ESG. ESG includes things like quality control, risk mitigation, and stakeholder relations, all of which help the company make better decisions. Businesses that prioritize sustainability and have a thorough understanding of it are able to spot dangers that might not have been noticed before.

Most firms that have a strong, persistent commitment to pursuing a sustainable development strategy and have achieved many achievements in disclosing ESG indicators over the years have always attracted the support of domestic and foreign investors.

The trend of transforming business operations based on global ESG criteria is one of the effective solutions for Vietnamese SMEs in the coming time. The trend of sustainable investment in the world is increasingly popular, so the disclosure of non-financial information in sustainable development reports is a necessary condition for SMEs to access FDI capital from ESG funds—investment funds according to ESG criteria.

State management agencies should promote and encourage SMEs to disclose ESG information in an increasingly transparent and reliable manner by improving the scoring mechanism and publishing the rankings of SMEs' sustainable development reports. This will provide a reference basis to encourage high-ranking SMEs with preferential mechanisms on tax policies and preferential policies when investing as well as when participating in bidding.

Human resource training institutions such as universities should improve the quality of training in producing professionals with adequate knowledge not only in finance but also in environmental, social and governance disciplines.

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