

Discussion on the Path of ESG Performance Alleviating Corporate Financial Constraints and Optimizing Investment Activities from the Perspective of Corporate Finance

Qin Li

School of Business, Nanjing Normal University, No.1 Wenyuan Road, Qixia Distric, Nanjing, Jiangsu Province, 210023, P.R.China

Abstract: From a corporate finance theoretical viewpoint, this paper explores potential structural channels through which environmental, social, and governance (ESG) performance can reduce corporate financing restrictions and enhance corporate investment efficiency. The article conceptualises superior sustainability performance as a potential governance and information mechanism that may lessen core market frictions, rather than conceptualising ESG participation just as an ethical commitment or public relations posture. By combining foundational theories of information asymmetry, agency costs, and capital structure with modern sustainability literature, this paper discusses how ESG performance may be linked to lower external financing frictions, stronger managerial oversight, and broader access to institutional capital. It also shows how simultaneous reductions in external financing costs and improvements in internal oversight might potentially assist reduce under-investment of potentially lucrative initiatives and restrict over-investment into value-destroying activities. The study closes with practical insights for linking materiality-focused sustainability disclosure with long-term business financial strategy.

Keywords: ESG performance, financing constraints, investment efficiency, information asymmetry, agency costs, cost of capital.

1. Introduction

In the current research of corporate finance, external financing limitations and inefficient capital allocation are two basic market frictions, which are always hindering the growth of enterprises, the durability of enterprises and the productivity of macroeconomics. Under typical neoclassical assumptions, where capital markets are frictionless, external funding is a frictionless substitute for internal funds, and any projects with positive net present value may be financed by companies. In real-world markets, ubiquitous information asymmetry between business insiders and outside investors creates a large gulf between internal and external costs of capital. Under-investment is a recurring problem. When internal liquidity is insufficient, financially restricted firms are often pushed to forego attractive capital projects.

Meanwhile, modern corporate arrangements which separate ownership from control are often afflicted by deep agency conflicts among shareholders, corporate executives and debt claimants. Without sufficient internal governance controls and external monitoring, corporate managers who have discretion over capital may pursue personal empire building, excessive risk avoidance, or short-term earnings management at the direct expense of long-run firm value. These moral hazard effects lead to large scale overinvestment in unproductive, high-cost or value-destroying initiatives. Addressing both the under-investment caused by financial restrictions and the over-investment arising from management agency friction requires sophisticated internal contractual discipline and transparent external signalling methods.

In the past 20 years the environmental, social and governance (ESG) issues have gone from the sidelines of corporate social responsibility efforts to the core of global

company financial strategy and institutional capital allocation. Mainstream institutional asset managers, commercial banks, credit rating agencies and sovereign wealth funds systematically use non-financial ESG criteria in their portfolio screening, debt pricing models and risk evaluation frameworks. Instead, proactive ESG management may be considered as a corporate competency, contributing to risk management, stakeholder trust and increased organisational transparency.

This research systematically and theoretically studies the transmission mechanism of ESG performance from the perspective of corporate finance to ease corporate financing constraints and optimise capital investment operations. This study develops a rigorous conceptual framework by synthesising fundamental theories of capital structure and corporate governance with modern empirical and theoretical breakthroughs in sustainable finance. It contends that enhanced ESG engagement may minimise informational and agency frictions, facilitate access to funding, enhance managerial control, and promote efficiency in business investment.

2. Theoretical Foundations: Information Asymmetry, Agency Costs, and Capital Constraints

The economic analysis of financing limitations and distorted investment activity by corporations has a deep foundation in the traditional market friction literature. In the first contribution of pecking order theory, Myers and Majluf showed that when corporate managers have superior private information on project profitability and existing asset values over outside investors, an adverse selection discount for newly issued securities is demanded by external capital providers [1]. The informational asymmetry generates a

substantial financing wedge: the underpricing of equity issues leads to a dilution of existing shareholder wealth, causing rational managers to use internal finance and then debt before resorting to external equity. When internal cash flows and debt capabilities are limited, financially restricted firms have to give up positive net present value investment opportunities, which directly produces the structural issue of corporate under-investment.

Jensen developed the free cash flow hypothesis on the basis of a complementary view of contractual frictions to explain how agency conflicts between company executives and outside shareholders distort the deployment of capital [2]. Corporations with cash flows in excess of the requirements of profitable operational investments have powerful structural incentives for self-interested managers to retain and reinvest the surplus in the enterprise rather than distribute it to shareholders via dividends or share repurchases. This managerial empire building propensity enlarges the organization beyond its ideal size, magnifies executive salary and prestige, but at the same time causes serious capital misallocation and harmful over-investment in value-destroying projects.

To understand how informational transparency impacts these dual investment distortions, Biddle, Hilary, and Verdi established that a higher quality of financial reporting is a key governance tool that increases overall investment efficiency [3]. In particular, effective corporate disclosure minimises the information asymmetry between corporate insiders and external capital providers, thus decreasing external financing hurdles and mitigating under-investment for capital-constrained enterprises. At the same time, better reporting quality improves external scrutiny by shareholders, minimises moral hazard for managers and curtails over-investment for cash-rich corporations. Their results show that reducing informational opacity has symmetric effects on improving capital allocation.

Bénabou and Tirole extend corporate disclosure theory into the contemporary multidimensional space, looking for a variety of economic justifications for corporate social responsibility, such as the formation of a longer-term corporate perspective, and the expression of stakeholder-oriented prosocial preferences [4]. Their theory suggests that CSR may encompass incentives beyond the short-term profit maximisation, but also include costs and agency issues. Their paradigm also points to the contradiction between stakeholder-oriented CSR and possible agency costs, implying that the economic consequences of CSR rely on corporate motives and governance conditions.

Combined, these perspectives imply that increases in information openness and governance can help to lower finance frictions and discipline management capital allocation. Contemporary corporate finance may engage both systems via ESG-related disclosure and governance measures.

3. Transmission Pathways of ESG Performance in Alleviating Corporate Financial Constraints

The main transmission channel for greater ESG performance to reduce corporate financing limitations is the significant reduction of information asymmetry between company insiders and external capital markets. Dhaliwal, Li, Tsang and Yang proved that voluntary start and transparent release of standalone corporate sustainability reports lead to a

reduction in a firm's ex-ante cost of equity capital, especially for firms that reveal exceptional non-financial performance [5]. Corporations disclose forward-looking operational information about environmental compliance, workforce management, customer safety procedures, and supply chain governance, providing external analysts and institutional investors with a complete set of non-financial intelligence that illuminates the internal risk architecture and improves the accuracy of forecasts.

Higher information transparency may reduce financing costs, although the extent and nature of this link may differ between companies and financial markets. According to El Ghoul, Guedhami, Kwok and Mishra, firms with better social and environmental performance exhibit significantly reduced ex-ante cost of equity capital in different market conditions [6]. Capital markets routinely reward sustainable operational methods with lower equity risk premiums, because high-performing ESG companies demonstrate lesser vulnerability to environmental litigation, labour disputes, regulatory penalties, and consumer boycotts. Transparent ESG reporting is an effective signalling device that lowers investor estimation risk and helps to broaden the institutional equity investment base.

[7] Goss and Roberts adduce evidence that corporate social responsibility is related to bank loan pricing. They document that loan spreads are somewhat greater for firms with social responsibility concerns, but the lenders' reactions to discretionary CSR expenditure differ by borrower quality. Their findings therefore suggest that CSR-related features can enter credit assessment, but they do not mean to say that all high-CSR enterprises have universally advantageous lending terms.

Evidence that stronger corporate sustainability performance is connected with better access to finance and lower capital limitations is provided by Cheng, Ioannou, and Serafeim (2014) [8]. They find stakeholder involvement and increased disclosure transparency as two potential ways to mitigate agency and information frictions. These findings indicate that sustainable policies can influence finance circumstances, provided they strengthen stakeholder relationships and the information environment for external capital providers.

Moreover, Bae, El Ghoul, Guedhami, Kwok, and Zheng verified that good corporate social responsibility decreases the economic costs of high financial leverage during strong product market competition by maintaining stakeholder confidence and reducing predation by rival firms [9]. Highly indebted enterprises generally see large drops in market share as customers and suppliers, being risk cautious, are concerned that the firm would go into difficulties. Their findings imply CSR can compensate for some of the product-market costs of high leverage, by allowing them to retain their consumers and minimising their exposure to competitors [9].

Together, these theoretical and empirical research imply that higher ESG or CSR performance may help alleviate some external finance frictions by enhancing information transparency, stakeholder interactions, and access to capital.

4. Mechanisms of ESG Performance in Optimizing Corporate Investment Activities

The optimisation of corporate investment operations through enhanced ESG performance works by addressing

both under-investment and over-investment distortions in the corporate investment lifecycle. In financially limited circumstances, many potential ideas for capital spending are deferred because of excessively expensive external capital barriers and acute liquidity shortfalls [1]. Better ESG performance reduces equity and debt financing constraints. It has access to external financing channels that are otherwise unavailable to capital-constrained enterprises. Thus, they are capable of conducting profitable research and development, green technology adoption, and capacity modernisation, which can potentially alleviate under-investment caused by financing constraints.

At the same time, good ESG performance inhibits managerial over-investment by means of a reinforced corporate governance structure. Corporate governance (the G dimension) is an essential pillar of ESG, including board independence, executive accountability, transparent auditor monitoring and responsiveness to stakeholders. These governance systems limit management empire-building and opportunistic cash hoarding [2]. For ESG-committed enterprises, the executive decisions on significant capital acquisitions, mergers and long-term project commitments face intense scrutiny from sustainability committees, independent directors and activist institutional shareholders, who must abide by strict public disclosure protocols and rigorous stakeholder reporting standards. The increased inspection limits managerial moral hazard and may diminish opportunistic capital allocation and increase scrutiny over significant investment decisions.

As Khan, Serafeim and Yoon [10] demonstrated, firms that are high performers on material sustainability issues outperform firms that are low performers on material sustainability issues, but this benefit does not hold for immaterial sustainability issues. This study shows that the financial relevance of sustainability investment could be highly contingent on whether the underlying ESG issues are substantial to the firm's industry and operations. In contrast, there may not be the same financial benefits to the investment in immaterial ESG issues. This points to the need to prioritise sustainability issues that are economically relevant to the firm's industry.

Gillan, Koch and Starks provide a general overview of the corporate finance literature tying ESG and CSR to the business risk, performance, value, ownership and governance characteristics, while acknowledging that major empirical problems remain open [11]. In view of this literature, corporations may choose to incorporate financially material ESG risks into their valuation of project cash flows, discount rates and long-term capital commitments.

Taken together, these mechanisms imply that ESG performance can increase investment efficiency through alleviating some of the financial frictions associated with underinvestment and improving monitoring measures that might reduce wasteful overinvestment.

5. Strategic Synergy, Implementation Challenges, and Governance Alignment

To transform ESG excellence into long-term corporate financial benefits, companies need to develop a coherent strategic synergy between corporate sustainability goals and capital allocation frameworks. Non-financial performance indicators cannot fester in public relations departments; they

must be entrenched in the chief financial officer's capital budgeting processes, debt issuance plans, and investor relations frameworks.

First, there is the risk that sustainability disclosure becomes divorced from underlying operational practice. As the ESG and CSR literature shows varied and context-dependent correlations with corporate risk, performance and value, disclosure alone should not be taken as evidence of financial gain [11]. Instead, a continuous discrepancy between declared promises and actual corporate behaviour may diminish the trust of sustainability information.

Second, firms should not fall into the trap of non-focused sustainability spending. Research on materiality indicates that organisations could get higher financial relevance from sustainability programs that address concerns material to their industry, but similar benefits are not routinely seen for immaterial ESG issues [10]. Executive teams should scrutinise stakeholder materiality to determine what environmental and social issues have a direct bearing on the competitive positioning and cost structure of their sector.

Another implementation challenge relates to the quality and comparability of ESG information utilised in financial decision-making. Sustainability indicators vary greatly by industry in their scope, measurement boundaries, and usefulness, and hence a simple aggregation of ESG scores might be misleading. Materiality is thus applicable when non-financial information is incorporated by managers into capital budgeting. Evidence on material sustainability issues implies that the financial importance of ESG performance relies on how close the underlying environmental or social issue is to the firm's operating setting [10]. In practice, finance teams should distinguish between indications that may alter predicted cash flows, risk exposure, financing circumstances or asset valuations, and indicators that are mainly descriptive. This distinction can help alleviate the possibility that ESG factors will be just another layer of reporting without boosting investment analysis. It also enables more transparent internal decision rules, since managers can explain why certain sustainability factors are used in project evaluation and why others are tracked for wider stakeholder or compliance reasons. The broader ESG and CSR literature also suggests that the links between sustainability performance and corporate results are varied and context-dependent [11]. This is why ESG information should be used as a complement to conventional financial research, not as a substitute for it. A tighter mapping between ESG characteristics and financial repercussions can also increase the consistency among investment proposals, since projects can be analysed using comparable assumptions on regulatory risk, operational resilience, stakeholder dependency and long-term resource requirements.

Third, executive remuneration systems should be redesigned to align managerial incentives with multi-dimensional ESG milestones. Linking long-term executive incentives to well defined and verifiable ESG criteria may help to link managerial decision-making with longer-term sustainability objectives. However, the efficiency of such arrangements is dependent on target design, materiality and monitoring quality. By including meaningful non-financial performance indicators into executive compensation, corporate decision-makers are structurally incentivised to focus on sustainable, long-term capital investments rather than shortsighted quarterly earnings manipulation.

Fourth, overhaul board oversight mechanisms. Committees

focused on sustainability and risk, with applicable environmental, technical and regulatory knowledge, may enhance the assessment of capital investment proposals against developing risks and market expectations. Independent board monitoring can also improve scrutiny of capital spending decisions and lower the risk of expenditures that do not have clear long-term economic benefit.

Finally, corporate communication tactics can be improved by integrated reporting systems that link financially material sustainability information to conventional financial metrics. This incorporation can give outside providers of finance with a clearer basis to assess how sustainability related risks and opportunities may impact firm financial performance. More coherent reporting might consequently increase information openness and foster more sophisticated appraisal of capital market, however its financial impacts are likely to rely on the quality of disclosure, materiality and firm-specific conditions.

6. Conclusion

In the corporate finance view, ESG performance can serve as a significant governance and information mechanism to alleviate some financing frictions and investment inefficiencies. Higher ESG performance may be related to cheaper financing costs and wider access to external finance by boosting information openness and stakeholder involvement.

At the same time, including governance frameworks and material sustainability considerations may enhance managerial control and improve the quality of capital allocation. Such mechanisms give theoretical underpinnings for understanding how ESG engagement could be associated with funding restrictions as well as investment efficiency, however consequences are expected to differ between enterprises, industries and institutional environments.

To summarise, the future of corporate financial management may benefit from incorporating financially material ESG factors into capital budgeting, risk management and governance frameworks to improve financial resilience and capital allocation, while recognising that the financial effects of ESG practices remain context-dependent.

References

[1] Myers, S. C., & Majluf, N. S. (1984). Corporate financing and investment decisions when firms have information that

investors do not have. *Journal of Financial Economics*, 13(2), 187–221. [https://doi.org/10.1016/0304-405X\(84\)90023-0](https://doi.org/10.1016/0304-405X(84)90023-0)

[2] Jensen, M. C. (1986). Agency costs of free cash flow, corporate finance, and takeovers. *American Economic Review*, 76(2), 323–329. <https://doi.org/10.2139/ssrn.99580>

[3] Biddle, G. C., Hilary, G., & Verdi, R. S. (2009). How does financial reporting quality relate to investment efficiency? *Journal of Accounting and Economics*, 48(2–3), 112–131. <https://doi.org/10.1016/j.jacceco.2009.09.001>

[4] Bénabou, R., & Tirole, J. (2010). Individual and corporate social responsibility. *Economica*, 77(305), 1–19. <https://doi.org/10.1111/j.1468-0335.2009.00848.x>

[5] Dhaliwal, D. S., Li, O. Z., Tsang, A., & Yang, Y. G. (2011). Voluntary nonfinancial disclosure and the cost of equity capital: The initiation of corporate social responsibility reporting. *The Accounting Review*, 86(1), 59–100. <https://doi.org/10.2308/accr.00000009>

[6] El Ghoul, S., Guedhami, O., Kwok, C. C. Y., & Mishra, D. R. (2011). Does corporate social responsibility affect the cost of capital? *Journal of Banking & Finance*, 35(9), 2388–2406. <https://doi.org/10.1016/j.jbankfin.2011.02.007>

[7] Goss, A., & Roberts, G. S. (2011). The impact of corporate social responsibility on the cost of bank loans. *Journal of Banking & Finance*, 35(7), 1794–1810. <https://doi.org/10.1016/j.jbankfin.2010.12.009>

[8] Cheng, B., Ioannou, I., & Serafeim, G. (2014). Corporate social responsibility and access to finance. *Strategic Management Journal*, 35(1), 1–23. <https://doi.org/10.1002/smj.2131>

[9] Bae, K.-H., El Ghoul, S., Guedhami, O., Kwok, C. C. Y., & Zheng, Y. (2019). Does corporate social responsibility reduce the costs of high leverage? Evidence from capital structure and product market interactions. *Journal of Banking & Finance*, 100, 135–150. <https://doi.org/10.1016/j.jbankfin.2018.12.014>

[10] Khan, M., Serafeim, G., & Yoon, A. (2016). Corporate sustainability: First evidence on materiality. *The Accounting Review*, 91(6), 1697–1724. <https://doi.org/10.2308/accr-51307>

[11] Gillan, S. L., Koch, A., & Starks, L. T. (2021). Firms and social responsibility: A review of ESG and CSR research in corporate finance. *Journal of Corporate Finance*, 66, 101889. <https://doi.org/10.1016/j.jcorpfin.2020.101889>