Jurnal Riset Akuntansi
dan Keuangan
Journal homepage: https://ejournal.upi.edu/index.php/JRAK/

The Influence of Environmental, Social, and Governance (ESG) on Corporate Financial Performance

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A B S T R A C T

This study investigates the impact of Environmental, Social, and Governance (ESG) factors on corporate financial performance. The research focuses on companies listed on the Indonesia Stock Exchange in 2023. A purposive sampling technique was employed, yielding a final sample of 74 companies that met the selection criteria. The study utilizes simple regression analysis to examine the relationship between ESG and financial performance. ESG performance is measured using ESG scores published by Morningstar Sustainalytics, while financial performance is assessed based on Return on Assets (ROA). The results indicate a positive and significant relationship between ESG performance and financial performance, suggesting that companies with good ESG scores tend to achieve better financial outcomes.

I N F O A R T I K E L

Article History:
Submitted/Received 01 January 2025
First Revised 05 January 2025
Accepted 13 January 2025
First Available online 26 April 2025
Publication Date 26 April 2025

Keyword:
Environment, Financial Performance, Governance, Social

1. INTRODUCTION

The assessment of corporate performance is no longer solely focused on financial indicators but has evolved toward a more comprehensive evaluation that includes environmental, social, and governance (ESG) aspects. This shift is driven by the increasing awareness of global climate change and environmental degradation, which, if left unaddressed, could lead to significant economic losses. In Indonesia, the total cost of climate change mitigation reaches IDR 4 trillion per year. Furthermore, Indonesia's Gross Domestic Product (GDP) is projected to decline by 19% if global temperatures rise by 4 degrees Celsius. Additionally, 25% of Indonesia's economy is associated with high carbon intensity, particularly in the mining sector (14.07%), agriculture (9.22%), fisheries (2.58%), and forestry (0.6%). Indonesia is also at risk of incurring economic losses ranging from IDR 110 trillion to IDR 577 trillion, equivalent to 25% of the national budget, due to climate change if it fails to adopt risk-based management for coastal and small island ecosystems.The impacts of global warming and environmental degradation have raised awareness among stakeholders regarding the importance of considering ESG factors as non-financial elements in investment decision-making. A study conducted by the UN Global Compact on sustainability, involving 1,230 CEOs across 113 countries and 21 industries, found that 62% of CEOs acknowledge the urgency of accelerating the transition toward sustainable business models (Setiani, 2023).

The Indonesian Financial Services Authority (Otoritas Jasa Keuangan, OJK) issued Regulation No. 51/POJK.03/2017 on the Implementation of Sustainable Finance for Financial Institutions, Issuers, and Public Companies. Article 10 of this regulation mandates that Financial Institutions, Issuers, and Public Companies must prepare a Sustainability Report, with the reporting obligation formally implemented starting in 2019. These reports are expected to communicate corporate performance and its impact, providing stakeholders with information on economic, social, and environmental performance through sustainability reporting mechanisms (Tarigan & Semuel, 2015). Sustainable economic development necessitates adherence to ESG principles, and well-structured ESG disclosures are expected to serve as a crucial non-financial basis for investors in making investment decisions.

Numerous studies have examined the relationship between ESG and financial performance, yet findings remain inconsistent. Several studies (Husada & Handayani, 2021; Nugroho & Hersugondo, 2020; A. Pratama et al., 2024; Safriani & Utomo, 2020; Zahroh & Hersugondo, 2021) have found that ESG positively and significantly influences financial performance. ESG disclosures can enhance public and stakeholder trust, leading to greater consumer confidence in corporate products or increased capital investments in the form of assets, which in turn improve corporate operations and profitability (Zahroh & Hersugondo, 2021). Nugroho & Hersugondo (2020) further argue that ESG information serves as a positive signal for investors and stakeholders in making decisions that ultimately enhance financial performance.

However, some studies present contrasting findings. Research by Grisales & Caracuel (2021) indicates that companies with strong ESG scores tend to be less profitable due to the high costs associated with ESG implementation, which may reduce corporate earnings. Similarly, Climent (2018) found that companies engaging in ethical business practices incur higher expenditures on social projects, thereby sacrificing financial returns. Additionally, research by Husada & Handayani (2021) suggests that ESG has no significant effect on financial performance, particularly in the financial sector, where many companies have yet to adopt comprehensive interdimensional corporate governance practices, resulting in incomplete ESG disclosures.

DOI: https://doi.org/10.17509/jrak.v13i1.80514
p- ISSN 2338-1507 e- ISSN 2541-061X

This study aims to examine how ESG influences financial performance among companies listed on the Indonesia Stock Exchange. The research specifically focuses on listed companies that have ESG scores provided by Morningstar Sustainalytics. This study contributes to the existing literature by comprehensively analyzing the impact of ESG on corporate value.

Signaling theory was first introduced by Spence (1973) in his study titled “Job Market Signaling”, which explains that the sender (the information owner) provides a signal or indication in the form of information that reflects the condition of a company, which is beneficial for the receiver (investor). Signaling theory assumes that corporate managers possess more information about the company’s quality than external investors. Therefore, positive signals in the form of relevant information are required from the company to aid investment decision-making. Non-financial ESG information, which includes corporate practices concerning environmental, social, and governance aspects, serves as a signaling mechanism that companies can provide to investors. Generally, investors interpret this information as either good news or bad news. If the signal conveyed by the company indicates good news, it will lead to an increase in stock trading volume and, consequently, an improvement in corporate performance (Safriani & Utomo, 2020).

Financial performance is a measure of a manager's success in running a company. It reflects a company’s ability to generate profits or returns on the resources invested in it. The purpose of measuring corporate performance is to obtain information related to the efficiency of fund utilization, which can assist management in making optimal decisions for the company (Husada & Handayani, 2021). Strong financial performance is essential for achieving long-term and sustainable success.

ESG is a component of corporate social responsibility (CSR) disclosures that focuses on environmental, social, and governance performance (Triyani & Setyahuni, 2020). ESG comprises factors used to assess corporate or investment performance, specifically environmental, social, and governance aspects (Prabawati & Rahmawati, 2022). The development of ESG in Indonesia has demonstrated a positive trend in recent years, as more companies and investors are beginning to understand and adopt sustainable approaches encompassing environmental, social, and governance aspects. ESG has also become a critical source of information for investors in making investment decisions, influencing stock price appreciation and corporate performance (Arofah & Khomsiyah, 2023).

Hypothesis

ESG is interpreted by investors as a strong signal of future stock performance growth and as a risk mitigation tool during crises (Broadstock et al., 2020). According to Nugroho & Hersugondo (2020), ESG disclosure is perceived by companies as a positive signal that is expected to be well received by stakeholders and utilized in decision-making. The disclosure of both financial and non-financial environmental-based information can influence investment decisions. Investment decisions tend to be greater when companies disclose non-financial environmental information that focuses on preventive measures (Rokhayati et al., 2019). Appropriate investment decisions can enhance profitability and overall corporate performance.

Support from stakeholders plays a crucial role in ensuring a company’s sustainability (Ghozali & Chariri, 2014). ESG disclosure aims to position companies positively in their business activities, thereby securing stakeholder support. This, in turn, increases working capital and enhances company operations through financial backing, ultimately leading to higher profitability from product sales. A positive ESG score is also associated with higher

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asset returns (Buallay, 2019). Consequently, an increase in ROA can be expected as a result of higher corporate profits.

H: ESG has a positive influence on corporate financial performance.

2. METHODOLOGY

This study adopts a quantitative research approach utilizing secondary data obtained from published financial reports on the Indonesia Stock Exchange. The population comprises companies listed on the Indonesia Stock Exchange that have ESG scores recorded in the Morningstar Sustainalytics Index for the year 2023. The sampling method employed is purposive sampling, resulting in a final sample of 74 companies in 2023.

Table 1. Criteria of Purposive Sampling

Criteria	Total
Companies listed on the Indonesia Stock Exchange (IDX) that have ESG scores in the Morningstar Sustainalytics Index	79
Companies listed on the Indonesia Stock Exchange (IDX) that have ESG scores in the Morningstar Sustainalytics Index but did not publish financial reports in 2023	(5)
Total research sample	74

Operational Definition

Environmental, Social, and Governance

The variables employed in this study include ESG as the independent variable and financial performance as the dependent variable. ESG, which comprises environmental, social, and governance factors, is measured using ESG scores provided by Morningstar Sustainalytics. The Indonesia Stock Exchange (IDX) collaborates with Morningstar Sustainalytics to conduct ESG assessments. Sustainalytics applies a risk decomposition approach, wherein companies face two primary ESG challenges: exposure and management. Based on ESG assessment scores, companies are classified into one of the following five categories:

Table 2. ESG Risk Score

ESG Risk Score	Category	Description
0-10	Negligible (Can be disregarded)	Considered to have a negligible ESG risk (can be disregarded)
10-20	Low	Considered to have a low ESG risk
20-30	Medium	Considered to have a moderate ESG risk
30-40	High	Considered to have a high ESG risk
>40	Severe	Considered to have a severe ESG risk

Financial Performance

Financial performance is a critical measure of a company's financial health, and it is essential for companies to maintain and even enhance their financial performance to achieve long-

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term success and sustainability (Setiani, 2023). The dependent variable, financial performance, is assessed through the analysis and evaluation of corporate financial reports. The approach used to evaluate financial performance in this study is Return on Assets (ROA), which reflects a company's ability to generate returns from its assets. ROA provides a more comprehensive measurement of overall returns, encompassing both debt and equity financing (Indrawati et al., 2020). ROA is calculated by dividing profit before tax by total assets (Pratama, 2016).

$$Financial\ Performance = \frac{\text{Profit Before Tax}}{Total\ Assets}$$

Analysis Method

The data analysis in this study begins with descriptive statistical analysis, followed by classical assumption tests, which include normality test, multicollinearity test, and heteroscedasticity test. The next stage involves conducting simple linear regression analysis as a hypothesis testing procedure to obtain the coefficient of determination, F-statistic, and t-statistic values. Simple linear regression analysis is employed to examine whether ESG has a positive influence on financial performance. The regression equation used in this study is as follows:

$$\text{ROA} = \alpha + \beta\ ESG + e$$

Description:
ROA = Return on Assets
α = Constant
β = ESG Coefficient
e = Error

3. RESULT AND DISCUSSION

Descriptive Analysis

Table 3. Descriptive Statistical Test Results After Data Transformation

Variable	N	Minimum	Maximum	Mean	Std. Deviation
ESG	74	12,67	53,10	29,1887	9,53306
ROA	74	0,00	0,37	0,0924	0,07893

Source: Data processed 2024

The descriptive statistical test provides an overview or summary of the data based on the mean, standard deviation, minimum value, and maximum value. As shown in Table 3, both ESG and ROA have mean values greater than their standard deviations. This indicates the homogeneity of the variables and demonstrates that the data used in this study is of good quality.

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Classical Assumption Test Results

Table 4. Classical Assumption Test Results

Test Type	Value	Explanation
Normality Test (One-Sample Kolmogorov-Smirnov Test)	0,067 > 0,05	Data distribution is normal
Multicollinearity Test (Collinearity Diagnostic)	Tolerance 1,00 VIF 1,00	No multicollinearity
Heteroscedasticity Test (Glejser Test)	Sig 0,150 > 0,05	No heteroscedasticity

To verify that the independent and dependent variable models follow a normal distribution, a normality test was conducted using the One-Sample Kolmogorov-Smirnov test. The test yielded a significance value of 0,067, which is greater than 0,05, indicating that the data is normally distributed. Next, a multicollinearity test was performed to assess potential correlations among the independent variables. Multicollinearity was evaluated based on the Tolerance and Variance Inflation Factor (VIF) values. The results indicate that the tolerance value exceeds 0,10, and the VIF value is below 10, confirming that no multicollinearity is present in the model. Additionally, the study employs the Glejser test to examine heteroscedasticity. According to the decision rule for the Glejser test, a significance value greater than 0,05 suggests the absence of heteroscedasticity. The results indicate a significance value of 0,150, confirming that heteroscedasticity is not present in the dataset.

Hypothesis Testing Results

Table 5. Hypothesis Testing Results

Constant	0,027
Regression Coefficient	0,002
R^2	0,082
F (calculated)	5,288
t (calculated)	2,299
t table	1,668
Significance	0,025

Hypothesis testing in this study employs the simple linear regression analysis method. Regression analysis is used to determine the effect of the independent variable on the dependent variable. Based on the hypothesis testing results presented in Table 5, the linear regression equation model can be formulated as follows:

$$ROA = 0{,}027 + 0{,}002\ ESG + e$$

The coefficient of determination (R^2) is 0,082, indicating that 8,2% of the variation in Return on Assets (ROA) can be explained by the ESG variable. The remaining 91,8% is influenced by other factors outside the regression model. The F-statistic value is 5,288, which is statistically significant at α = 0,05, with a p-value of 0,000 (i.e., p < 0,05). This result suggests that the model is appropriate for predicting the effect of ESG on financial performance. The t-test results show a regression coefficient of 0,002, with a positive direction, and a significance value of 0,025 (p < 0,05). This indicates that the ESG variable has a significant positive effect on financial performance. Furthermore, the t-calculated value (2,229) is greater than the t-

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table value (1,668), confirming that the hypothesis is accepted. Therefore, it can be concluded that ESG positively influences financial performance.

Discussion

The findings of this study align with signaling theory, as proposed by Spence (1973). The signals conveyed by companies in the form of information about both financial and non-financial performance, as well as the achievements of management, are intended to fulfill the expectations and preferences of investors (Taniman & Jonnardi, 2020). In this context, non-financial aspects, particularly Environmental, Social, and Governance (ESG) factors, serve as a positive signal for investors amid growing concerns over environmental degradation. Safriani & Utomo (2020) assert that ESG disclosure indicates that companies are not solely focused on profit maximization, but also consider the environmental and social impacts resulting from their operational activities.

This study is consistent with previous research conducted by Husada & Handayani (2021), Nugroho & Hersugondo (2020), A. Pratama et al. (2024), Safriani & Utomo (2020), and Zahroh & Hersugondo (2021), which found that ESG has a positive effect on financial performance, as proxied by Return on Assets (ROA). The results suggest that ESG disclosure, encompassing environmental, social, and corporate governance aspects, is perceived as a positive signal by investors, which in turn influences their decision-making process. Ultimately, this dynamic contributes to the overall improvement of corporate financial performance.

4. CONCLUSSION

Based on the analysis presented above, it can be concluded that ESG has a positive influence on financial performance. This study provides practical implications for investors in making investment decisions, as well as useful insight for stakeholders in their decision-making processes. Additionally, this research contributes to the existing literature by examining the impact of ESG on corporate financial performance. However, this study has certains limitations, particulary the one-year time frame used for analysis. Future research may consider extending the study period and incorporating additional variables that could further strengthen the understanding of ESG's impact on financial performance.

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DOI: https://doi.org/10.17509/jrak.v13i1.80514
p- ISSN 2338-1507 e- ISSN 2541-061X

DOI: https://doi.org/10.17509/jrak.v13i1.80514
p- ISSN 2338-1507 e- ISSN 2541-061X