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The Effect of Environmental, Social, and Governance (ESG) Risks on Firm Value with Financial Performance as An Intervening Variable

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Abstract

This research aims to determine the influence of Environmental, Social, and Governance (ESG) risk on firm value with financial performance as an intervening variable. The intervening variable used in this research is financial performance as measured by the Return on Assets (ROA) ratio. Independent variables in this research, ESG risk is measured by the ESG Risk Score. The dependent variable used in this research is value companies as measured by Tobin's Q. The population of this study is companies listed in the IDX ESG Leaders index. The sampling method used was purposive sampling, and 15 companies were selected that met the criteria as research samples. The analytical method used is SEM-PLS `with SmartPLS 3 software. The results of this study show that ESG risk has a positive effect on firm value. Research also shows that ESG risk has a positive and significant effect on financial performance, and financial performance has a positive and significant effect on firm value. So that financial performance in this research can be used as an intervening variable.

Keywords: Environmental, Social, and Governance, Firm Value, Financial Performance, Environmental, Social, and Governance Risk.

INTRODUCTION

Firm value is the main goal of a business organization (Priharta et al., 2022). Firm value is the company's performance reflected through stock prices formed by the demand and supply of the capital market which provides an overview of the public's assessment of the company's performance (Mayangsari, 2018). Corporate value is also the investor's perception of the success of a company (Jihadi et al., 2021). Given that the company's goal is to always increase the company's value, the company must be very considerate in making decisions and taking into account their impact on stock prices (S & Machali, 2017). The bigger a company, the more attention it gets from stakeholders, so that growing companies will invest more in areas that can realize social value, which will have a positive impact on increasing the company's value (Burke *et al*., 1986 in Chang & Lee, 2022). Therefore, businesses, especially profitoriented ones, must prioritize the improvement of company value (Utomo & Simanungkalit, 2024).

Along with the development of the era, stakeholders are not only focused on financial performance alone, but also began to pay attention to environmental issues that require companies to start paying attention to the implementation of their business in the long term. In their business activities, companies must develop sustainable concepts and environmentally friendly industries that are integrated, comprehensive, and efficient (Maulana et al., 2024). A manager's strategic actions to increase the company's value in the future are ultimately influenced by the environment because the company must survive the competition or gain a competitive advantage (Chang & Lee, 2022). To be sustainable and gain a competitive advantage, companies must focus on minimizing the negative impact of their activities on the environment through product innovation and strategy implementation (Atan et al., 2018). As the business grows, more and more stakeholders, including consumers, local communities, governments and local governments, and environmental groups, are demanding ESG responses from companies. ESG activities become strategic decisions for managers to increase the company's value in the future (Chang & Lee, 2022).

The implementation of ESG aspects in companies in Indonesia has also begun to be noticed with the launch of the ESG Leaders index by the Indonesia Stock Exchange (IDX). The ESG Leaders index is an index that measures the price performance of issuers that have good ESG ratings and are not involved in significant controversies and have good transaction liquidity and financial performance. IDX is currently partnering with Morningstar Sustainalytics to conduct ESG assessments. The ESG score used in the ESG Leaders Index is a risk score that indicates how much risk can be caused by environmental, social, and governance to the company. Thus, stakeholders can assess the company's ability to manage risks related to ESG which will then affect the company's value.

This study is a development of research conducted by Yu-Jin Chang and Byung-Hee Lee in 2022 which analyzed the relationship between ESG and firm value. The study analyzed how ESG affects firm value through secondary data analysis in the form of ESG information from sustainability reports of 87 companies in Korea for the period 2002-2020 with industry concentration as a moderating variable. The results of this study concluded that ESG has a positive effect on firm value.

This study differs from previous studies because researchers suspect that there are other factors that can influence the relationship between ESG risk and firm value. ESG risk management has recently emerged as an important corporate paradigm, companies carry out business activities simultaneously to pursue two goals, namely social value and economic viability for sustainable development (Chang & Lee, 2022). In line with the implementation of ESG, the company's financial performance plays an important role in achieving firm value that is in line with the sustainability principles contained in ESG. A company must be in a good financial position to be able to contribute to the company's sustainable performance (Utpala & Adiwibowo, 2021). Thus, researchers suspect that profitability in financial performance can mediate the relationship between ESG risk and firm value.

Based on the explanation above, the purpose of this study is expected to be evidence that ESG risk affects the company's value which can then affect the company's financial performance. Thus, companies can realize the importance of mitigating ESG risk for the company's sustainable future.

THEORITICAL FRAMEWORK AND HYPOTHESIS

Stakeholder Theory

Stakeholder theory explains that companies should be able to benefit their stakeholders and are not entities that operate for personal gain (Katoppo & Nustini, 2022). Stakeholder theory argues that ESG-related actions are aligned with stakeholder interests and can improve company performance and firm value (Yu & Xiao, 2022).

Firm values

Firm value is the company's performance reflected through stock prices formed based on the demand and supply of the capital market that describes the public's assessment of the company's performance (Mayangsari, 2018). High firm value not only shows the credibility of the company's performance, but also the company's potential for progress in the future (S & Machali, 2017).

Environmental, Social, and Governance Risks

ESG risk is the risk related to environmental, social, and governance (ESG) impacts of business activities carried out by a company. The implementation of ESG in Indonesia is supported by the launch of the ESG Leaders index by the IDX. The ESG Leaders index is a stock index of the Indonesian stock exchange, which measures the price performance of each issuer that has a good ESG assessment and is not involved in significant controversies and also has good transaction liquidity and financial performance. IDX is currently partnering with Morningstar Sustainalytics as a third party to conduct ESG assessments. Sustainalytics is part of the Morningstar Company , which is a leading independent ESG and corporate governance research, ratings, and analysis company that supports investors worldwide in developing and implementing responsible investment strategies. ESG Risk Score provided by sustainalytics indicates how much risk can be caused by environmental, social, and economic aspects. governance . Furthermore, listed companies are grouped into one of 5 categories based on ESG score assessment, so that the following is obtained:

Table 1. ESG Category

Risk Score	Category	Description
0-10	Neglible	Considered to have neglible ESG Risk
10-20	Low	Considered to have low ESG Risk
20-30	Medium	Considered to have medium ESG Risk
30-40	High	Considered to have high ESG Risk
>40	Severe	Considered to have severESG Risk

Financial performance

Financial performance is the company's ability to control and manage its resources (Ikatan Akuntan Indonesia, 2007). Financial performance can also be interpreted as how a company can obtain income and growth (Devi Selvarajah et al., 2018). Financial performance analysis is considered important not only for the company itself but also for the company's stakeholders . To see whether a company has good quality, it can be seen from its financial performance (Hutabarat, 2020).

Environmental, Social, and Governance (ESG) Risks to Firm Value

Discussions around ESG risks are now a hot topic, especially for company shareholders. In stakeholder theory, companies must be able to meet the needs of their stakeholders , so that in addition to paying attention to company performance, ESG risk prevention is something that companies must fulfill in order to meet stakeholder expectations. In a growing industry, ESG will increase the company's agility to gain additional business and increase its value (Chang & Lee, 2022). Thus, ESG has an important role in increasing the company's value.
H1: *ESG risk has a positive effect on firm value*

Environmental, Social, and Governance (ESG) Risks to Financial Performance

In response to the growing intention of responsible investors to consider corporate performance in ESG risks when making investment decisions, companies have begun to adopt stakeholder-oriented strategies and maximize social value (Alsayegh et al., 2020). ESG is also seen as a fundamental investment and most investors buy stocks because of additional ESG-related information (van Duuren et al., 2016). Companies with high ESG risk scores are more likely to spend funds related to ESG risk issues in the future. ESG risk plays an important role in stakeholder decision making, which will also affect the company's financial performance.
H2: *ESG risk has a positive effect on financial performance.*

Financial Performance Against Firm Value

Growing financial performance means that the company's potential in the future is considered to be getting better, which suggests that the company's value will also be better according to investors' views. The higher the level of profit that the company is able to generate, the implementation of the company's operations in the future also has high prospects so that the company's value reflected in the company's stock price will increase (Supeno, 2022).
H3: *Financial performance has a positive effect on firm value.*

Mediation of Financial Performance on the Relationship between Environmental, Social, and Governance (ESG) Risk and Firm Value

As businesses grow, more and more stakeholders, including consumers, local communities, governments and local governments, and environmental groups, demand ESG risk responses from companies. ESG activities become strategic decisions for managers to increase the company's future value (Chang & Lee, 2022). However, a company must have a good enough financial condition to be able to contribute to the company's sustainable performance (Utpala & Adiwibowo, 2021). So along with the company's focus on increasing the company's value, the company must also pay attention to ESG risks while still paying attention to the company's financial performance.
H4: *Financial performance mediates the relationship between esg risk and firm value*

RESEARCH METHOD

Population and Sample

This study uses companies listed on the ESG Leaders index of the Indonesia Stock Exchange (IDX) as the population, while the sample in this study was selected using the purposive sampling method with the following criteria:
1. Companies included in the ESG Leaders index for the 2020-2023 period consecutively
2. Companies that have financial reports for the period 2020-2023

3. Companies that do not experience losses in the 2020-2023 period

Research Data

This study uses secondary data as a data source. Secondary data is obtained from online research in the form of annual reports that meet the specified criteria, as well as ESG scores available on the website (www.idx.co.id) which collaborates with Sustainalytics to provide data. Information related to ESG risk scores for companies listed on the ESG Leaders Index can be seen in the IDXESGL index evaluation announcement file which can be accessed on the IDX website (www.idx.co.id/id/data-pasar/data-saham/indeks-saham) with the search keyword "ESG Leaders" index.

This study uses a data processing method with the Structural Equation Modeling based on Partial Least Squares (SEM-PLS) modeling equation. SEM-PLS aims to test the predictive relationship between constructs by seeing whether there is a relationship or influence between the constructs (Hamid & Anwar, 2019). This study uses the SmartPLS 3.0 application to process data.

RESULT AND DISCUSSION

Data analysis

Descriptive Statistics

ESG risk provides an overview of the extent to which a company's operations have successfully managed environmental, social, and corporate governance issues in the implementation of its business. This research sample shows that each sample company has strong policies, actions, and management systems that are carried out to mitigate ESG-related risks, as reflected in the average ESG risk value of 3.357.

The firm value (Tobin's q) produces a minimum and maximum value of 0.336 and 21.814 which gives an illustration that the company's stock market value is 0.336 times and 21.814 times the book value. The stock market value is considered smaller than the book value if the Tobin's q value is below 1 and vice versa. The research data of the sample companies shows an average firm value (Tobin's q) of 1.755 which shows the stock market value is greater than the book value because the Tobin's q value is above 1, with a standard deviation of 2.780.

Profitability (ROA) of the sample company has a minimum and maximum value of 0.004 and 0.170, which shows that the company experienced a net profit of Rp. 0.004 and Rp. 0.170 from every use of Rp. 1 of the company's assets with an average of 0.058 and a deviation from the average of 0.037.

Table 2. Results of Descriptive Statistical Tests

	Mean	Median	Min	Max	Standard Deviation
ESG	3,357	3,000	3,000	4,000	0.479
ROA	0.058	0.048	0.004	0.170	0.037
Tobin'sQ	1,755	1,263	0.336	21,814	2,780
N-56					

Source: SmartPLS processed data, 2024

Evaluation of Measurement Model (Outer Model)

Convergent Validity

convergent validity value if the value of the loading factor exceeds 0.70 is considered good. The loading factor value of all research variables shows a value of >0.7, which means that the variables measured by these indicators can be trusted for further analysis purposes and can be considered valid.

Table 4. Convergent Validity Value

	ESG Risk	Financial Performance	Firm Value
ESG	1,000		
ROA		1,000	
Tobin's Q			1,000

Source: Data processed by SmartPLS, 2024

Discriminant Validity

Table 4.5 shows all cross loading values on each variable >0.70 so that the manifestation variables used in this study are sufficient in explaining the latent variables. This also confirms that all items show strong validity or discriminant validity .

Table 5. Cross Loading Values

	ESG Risk	Financial Performance	Firm Value
ESG Risk	1.000	0.350	0.174
Financial Performance	0.350	1.000	0.490
Firm Value	0.174	0.490	1,000

Source: Data processed by SmartPLS, 2024

Composite Reliability

Based on the data in Table 4.6, the Cronbach's Alpha and Composite Reliability values of all variables have values that exceed the threshold of 0.70. In addition, the results of the Average Variance Extracted (AVE) test also exceed the limit of 0.50 so that it can be suggested that the variables analyzed have been proven to have adequate validity and reliability.

Table 6. Composite Reliability Values

	Cronbach's Alpha	Rho_A	Composite Reliability	Average Variance Extraxted (AVE)
ESG	1.000	1.000	1.000	1.000
Financial Performance	1.000	1.000	1.000	1.000
Firm Value	1.000	1.000	1.000	1.000

Source: Data processed by SmartPLS, 2024

Structural Model Analysis (Inner Model)

R-squares (R^2)

This test is conducted to explain whether there is a substantive influence between certain exogenous latent variables on endogenous latent variables. R-Square values of 0.75, 0.50, and 0.25 indicate that the model is strong, moderate, and weak, respectively (Ghozali & Latan, 2015). The higher the $R^{2 \text{ value}}$, the better the prediction model and the proposed research model.

Hypothesis Testing

The research hypothesis (H1) assumes that ESG risk has a positive effect on firm value. The original sample value for the first hypothesis is 0.003 with a positive direction. Thus, the analysis is sufficient to support the first hypothesis so that it can be concluded that ESG risk has a positive effect on firm value so that hypothesis 1 (H1) is accepted with an alpha of 10%.

Table 7. R-Square Value (R^2)

	R Square	R Square Adjested
Financial Performance	0.123	0.106
Firm Value	0.240	0.212

Source: SmartPLS processed data, 2024

The research hypothesis (H2) predicts that ESG risk scores have a positive effect on financial performance. From the data analysis above, it can be seen that the original sample value for the second hypothesis is 0.350. The P-Value value is 0.005, thus it can be seen that empirical evidence supports the second hypothesis so that it can be concluded that ESG risk has a significant effect on financial performance so that hypothesis 2 (H2) is accepted.

The research hypothesis (H3) assumes that Financial Performance has a positive effect on Firm Value. The results of data analysis show that the original sample value for the third hypothesis is 0.489. The P-Value value is 0.000 which is lower than the significance level of 0.05. The positive direction of the coefficient indicates that the higher the Financial Performance will cause the Firm Value to increase. The P-Value value which is lower than the significance level illustrates that there is a significant influence between ESG and financial performance. Thus, it can be seen that empirical evidence supports the third hypothesis so that it can be concluded that Financial Performance has a significant effect on Firm Value so that hypothesis 3 (H3) is accepted.

Table 8. Hypothesis Testing

	Original Sample (O)	Sample Mean (M)	Standard Deviation (STDEV)	T Statistics	P Values	
ESG -> Firm Value	0.003	-0.073	0.153	0.018	0.985	Accepted
ESG -> Financial Performance	0.350	0.347	0.125	2.793	0.005	Accepted
Financial Performance -> Firm Value	0.489	0.529	0.081	6.036	0.000	Accepted

Source: SmartPLS processed data, 2024

Indirect Effect Test

This test was conducted to prove the mediating role of the profitability variable. The test results show that ESG risk has a significant positive effect on Firm Value through Profitability, with an original sample value of 0.171 or 17.1% and a P-Value of 0.045. So based on the research data, it can be concluded that Profitability is able to mediate the effect of ESG risk on Firm Value.

Table 9. Indirect Effect Testing

	Original Sample (O)	P Values
ESG -> Financial Performance -> Firm Value	0.171	0.045

Source: SmartPLS processed data, 2024

Discussion

Environmental, Social, and Governance (ESG) Risks on Firm value

The results of this study indicate that a company's low ESG risk value can encourage management to increase the company's value. Increasing preventive activities/actions carried out by the company related to environmental, social, and corporate governance risks on the impact of its business activities, which are proxied through the ESG Score on the IDX ESG Leaders Index, can increase the company's market value and assets.

Hypothesis (H1) in this study assumes that ESG risk has a positive effect on firm value. Based on table 3, ESG risk has an average value of 3.357, which illustrates that each sample company in mitigating ESG-related risks has a strong management system and actions, where the company's ability to mitigate its ESG risk will be a significant advantage for investors. Companies with good ESG risk mitigation capabilities will be more secure in carrying out their business which will then invite interest from investors to invest their capital. From the results of the hypothesis test in table 8, it can be seen that the original sample value for the first hypothesis is 0.003 with a positive direction. Thus, the analysis is sufficient to support the first hypothesis so that it can be concluded that ESG risk has a positive effect on firm value so that the hypothesis (H1) in this study is accepted with an alpha of 10%.

This study supports the stakeholder theory which states that ESG activities are in line with stakeholder interests and can improve company performance and firm value. ESG is information about a company's potential risks, and is used as an important strategy for long-term investment (Chang & Lee, 2022). Thus, companies that are able to mitigate their ESG risks well will be better able to survive in the long term and have the advantage to continue to increase firm value.

Environmental, Social, and Governance (ESG) Risk on Financial Performance

Hypothesis (H2) in this study assumes that ESG risk has a positive effect on financial performance. Based on table 8, the original sample value is 0.350, which means that the ESG risk score has a positive effect on financial performance. The results of this study have a significance value (P Value) of 0.005 (in accordance with a significance value of 0.05). This shows that there is a positive and significant influence between the ESG risk score and financial performance, so that the hypothesis (H2) in this study is accepted.

The results of this study indicate that increasing activities/actions taken by companies related to environmental, social, and corporate governance risks on the impact of business activities carried out can increase the company's return on assets ratio. This study is in line with research conducted by (Ahmad *et al*., 2021) where the results of the study revealed that ESG has an important and beneficial influence on stakeholders, one of which is related to the company's financial performance. Chang & Lee (2022) stated that ESG is information about the company's potential risks, and is used as an important strategy for long-term investment, thus increasing ESG performance which is depicted by a low ESG risk score can improve financial performance by preventing risks that may occur due to business operations. This is also in line with the concept of stakeholder theory which explains that companies must be able to benefit their stakeholders and not entities that operate for personal interests, so that companies not only focus on shareholder profits , but also pay attention to the environment and society.

The Influence of Financial Performance on Firm value

Hypothesis (H3) in this study assumes that financial performance has a positive effect on firm value. Based on table 8, the original sample value is 0.489, which means that financial performance has a positive effect on firm value. The results of this study have a significance value (P Value) of 0.000 (below the significance value of 0.05). This shows that there is a positive and significant influence between ESG and financial performance, so that the hypothesis (H3) in this study is accepted.

The results of the study indicate that increasing company profitability can increase the value of the company's shares and assets. This study is in line with research conducted by (Supeno, 2022) which states that profitability growth means that the company's potential for future development is considered better, meaning that the company's value in the eyes of investors is also better. This is in accordance with the concept of stakeholder theory which states that companies must be able to benefit their stakeholders, one of which is by maximizing profits for shareholders.

Financial Performance Mediates the Relationship Between Environmental, Social, and Governance (ESG) Risk and Firm Value

Hypothesis (H4) in this study assumes that financial performance is able to mediate the relationship between ESG risk and firm value. Based on the indirect effect test in table 9, the original sample value is 0.171, which means that financial performance has a positive mediating effect between ESG risk and firm value. The results of this study have a significance value (P Value) of 0.045 (below the significance value of 0.05). This shows that financial performance is able to mediate the relationship between ESG risk and firm value with a positive and significant relationship direction, so that the hypothesis (H4) in this study is accepted.

The alleged role of financial performance as a mediating variable is based on the research gap of the direct influence between ESG risk and firm value. Based on the results of this study, it can be concluded that financial performance proxied by the ratio of return on company assets can mediate the relationship between ESG risk and firm value. This means that increasing activities related to ESG risk carried out by the company can increase the company's profit, and increasing the company's profit can affect the increase in the company's stock price and assets so that the alleged financial performance variable as a mediator between the influence of ESG risk and firm value is proven to be able to mediate. This is in accordance with stakeholder theory where this theory states that the sustainability of the company depends on how the company is able to align so that each stakeholder 's interests can be balanced. From the perspective of this theory, both the environment, society, and shareholders are stakeholders that must be the company's concern.

CONCLUSIONS

This study aims to determine the effect of ESG risk on firm value and the effect of financial performance as a mediating variable. The study was conducted on companies included in the IDX ESG Leaders index for 4 years, namely in the period 2020-2023. From the explanation and research results in the previous chapter, the following conclusions were obtained:

1. ESG risk has a positive effect with an alpha of 10% on the value of companies listed on the IDX ESG Leaders Index . This means that an increase or decrease in the ESG risk score has a positive effect on the value of the company.

2. ESG risk has a positive and significant effect on profitability in companies listed on the IDX ESG Leaders Index . This means that the better the ESG risk score will lead to an increase in profitability.
3. Financial performance has a positive effect on firm value in companies listed on the IDX ESG Leaders Index . This means that increased profitability will lead to increased firm value.
4. Financial performance is able to mediate ESG risk against the value of companies listed on the IDX ESG Leaders Index . This shows that the better the ESG risk score can increase the value of the company through improved financial performance.

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