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Research Article

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

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Abstract: The purpose of this research is to test and analyze the relationship between Environmental, Social and Governance (ESG) and financial performance. The variables used in this research are Environmental, Social, and Governance as independent variables with the dependent variable being financial performance, which is proxied by ROA, ROE, and ROCE. The sampling technique used was non-probability sampling, purposive sampling so that there were 21 companies registered on Kompas 100 as samples observed from 2017 to 2022. The data analysis method in this research used Spearman correlation. The results of the Spearman correlation test inform that environmental is related to financial performance, which is proxied by ROE, ROA, and ROCE. Social and ROE have a relationship and have no relationship with ROA and ROCE. Governance and ROA are related but not ROE and ROCE. Based on these results, companies must continue to pay attention to and strive to implement ESG so that in the long term they can improve their financial performance.

Keywords: Environmental; Social; Governance; Financial Performance.

1. Introduction

The company strives to improve its performance, one of which is financial performance for the sustainability of the company so that it can survive and grow. Economic development and sustainable investment are becoming popular today so that current business developments also require companies to focus on environmental, social, and governance management or ESG. ESG is a business management principle and standard that follows certain criteria so that it can have a positive impact on the environment (environmental), social (social), and business governance (governance).

Companies that implement the first factor of ESG, namely environmental, strive to use environmentally friendly energy in their production activities, process the waste produced through various policies within the company. If the environment is not managed properly, it will cause an increase in temperature which can cause a disaster that will affect the economy of a country and ultimately affect the company's performance. The second factor is social, which is related to human resources where the fulfillment of rights, increasing welfare, and the quality of human resources in the company can increase employee productivity and improve company performance. The third factor is governance, which concerns how the company maintains relationships with management and investors.

With current developments, large investors in their decision-making considerations also pay attention to companies that integrate ESG. Companies included in the Kompas 100 are also often used as a basis for investor consideration because they are considered to have good liquidity performance and large market capitalization, but current developments require companies included in the Kompas 100 to also focus on integrating ESG. This can be seen from the increasing number of companies indexed in the Kompas 100 implementing ESG.

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Several previous studies measure the company's financial performance using ROA, ROE, and ROCE. Performance measurement with ROA measures the amount of the company's return from invested assets. Financial performance measurement with ROE measures the amount of return obtained by the company from capital, while another financial performance measurement is ROCE which measures the company's profit or loss from its assets and liabilities.

There are several conflicting findings regarding the influence of ESG on the company's financial performance, such as the findings of [1] and [2] who found that there was an influence of ESG on the company's financial performance. However, in the studies of [3], [4], and [5], found no influence of ESG on the company's financial performance.

From the presentation that has been delivered, the purpose of this study is to test and analyze the influence of Environmental, Social, and Governance (ESG) on the company's financial performance as measured using ROA, ROE, and ROCE in companies listed on Kompas 100. The urgency of this study is that the results of the study can be the basis for input for companies and investors whether ESG influences the company's financial performance, especially in companies listed on Kompas 100 so that companies can obtain input for improving company performance from ESG factors. In addition, for investors as a basis for making investment decisions.

2. Preliminaries or Related Work or Literature Review

ESG (Environmental, Social, Governance)

ESG is the principles and standards of business management that follow certain guides to positively affect the environment, social society, and governance. In addition, ESG is also a set of indicators that allow evaluating companies and deciding whether they are sustainable enough to operate in the long term and formulate value not just for shareholders but also towards society [6]. According to [7] ESG is a general term used to evaluate the non-financial performance of companies in three areas, namely environmental, social, and governance.

Environmental pillar measures a corporation's effect on its ordinary living and non-living environments containing air, land, and water, social pillar states a corporation's capacity to generate belief and fidelity with its workforce, clients, and community, and corporate governance pillar describes a corporation's systems and processes that purpose to make sure that its board members and executives work in the best interests of the corporation's long-term shareholders [8].

Financial Performance

Financial performance is a certain measure of a corporation's attainment in using assets from the company's business to generate profits [9]. As stated by [10] the evaluation of a corporation is seen from the resulting performance, especially the financial performance of a company, namely by evaluating the level of generated income.

Profitability ratios can be used to measure the level of generated income by a corporation, included in profitability ratios is return on assets (ROA), which is an accounting-based financial performance valuation that provides information about how profitable a corporation is in association to its total assets [11], return on equity (ROE) is a value of profitability that is based on a corporation's capability to generate income at a certain level of share capital [12]. Return on capital employed (ROCE) is also a measure to evaluate company performance, ROCE is the ratio of return on operating profit before tax from the business to the total capital used in the business [13].

Environmental Relationship to Financial Performance

The environmental pillar relates to how companies manage waste from production, create products that can be recycled and are environmentally friendly, use natural resources efficiently, and use technology that is environmentally friendly so that corporations are required to concern to the environment in producing and carrying out various activities.

Company activities related to environmental management must be disclosed to stakeholders, in this case stakeholders and the wider community, because according to [14]the corporation's ability to communicate environmental activities is considered important to

increase the reputation and trust of stakeholders including consumers so that it can have an impact on increasing company income. In addition, environmental management carried out proactively by companies to reduce negative impacts on the environment can be used as a source of competitive advantage and according to the resource-based view, improving the environment can lead to increasing company profitability [15].

Thus, the environmental pillar has an important role in the corporation's efforts to improve the corporation's financial performance which is seen through increasing profitability. This statement is supported by research results from [16], [1], [17], and [18], which states that the environment influences financial performance. However, according to [4], [19], and [15], the environment does not affect financial performance. Due to the inconsistency of the research results, the research hypothesis developed is:
H1: The environment has a relationship to financial performance.

Social Relationship to Financial Performance

The social pillar explains the company's relationship with employees, consumers, suppliers, government, and other parties who have an interest in the company. According to [8] social pillar measures the commitment and effectiveness of a company's management to create value-added products and services that uphold customer safety, maintain its reputation in the general community, safeguard human rights, maintain diversity and equal opportunities in its workforce, provide high-quality working conditions and workplaces, healthy and safe work, as well as offering training and development opportunities.

A company's commitment to the social pillar is necessary for the company so that the company can carry out its operational activities effectively and efficiently so that it can obtain good financial performance. For example, if the company provides a safe workplace for employees, employees will work calmly and focus in carrying out their work so that it will have an impact on improving the quality of their work which can contribute to improving the corporation's financial performance.

Implementation of the company's commitment to the social pillar according to [15] is realized by the company paying attention to the needs and requests of stakeholders, which can provide direction to the company in carrying out higher efficiency, and product differentiation which can create competitive advantages for the company. Apart from that, according to [14] corporations need reliable, competitive, creative, and effective resources to manage company assets to produce maximum profits, therefore social disclosure is very important to influence an organization's financial performance.

The importance of the social pillar on a corporate's financial performance is demonstrated by the results of research from [1], [17], and [18], who stated that social variables influence financial performance. The results of other research such as study conducted by [4], [19], and [15], show contradictory results, resulting in inconsistencies in research results to see the influence of social variables on financial performance. Thus, research hypotheses that can be formed is:
H2: Social has a relationship to financial performance.

Relationship of Governance to Financial Performance

Governance is the last pillar in ESG and is another important pillar apart from the environmental pillar and social pillar that must be paid attention to by companies. In the governance pillar, companies must pay attention to decision-making procedures, the behavior of the board of directors, and other matters related to the company's organizational system and structure.

Companies that want to improve their financial performance to be sustainable apart from having to pay attention to the environmental pillars and social pillars, the company must also have quality governance that supports every activity within the company. According to [15] the quality of governance is the combined effect of a series of factors such as cultural diversity and gender equality within the board, board size, director competency and expertise, and risk governance.

Governance quality alone is not enough to increase stakeholder trust, [8] state that governance must consider the effectiveness of board activities and functions. According to [20], effective governance practices include transparent decision making, accountability,

ethical behavior, and contributing to the perception of company legitimacy where these practices increase stakeholder trust and a strong governance structure encourages responsible decision making that contribute to long-term financial performance and sustainability.

Thus, the higher the level of governance, the better the corporation's level of compliance, which will have an impact on improving financial performance [20]. This statement is supported by the results of research conducted by [16], [1], [18], and [15], which stated that governance influences financial performance, while the results of research from [4], [17], and [21], stated that governance has no effect on financial performance. The inconsistency of research results relating to governance on financial performance gave rise to the research hypothesis:

H3: Governance is related to financial performance.

From the explanation above and the research hypothesis formed, this study aims to test and analyze the influence of ESG on company financial performance as valuated using ROA, ROE, and ROCE and the research model formed can be seen in Figure 1.

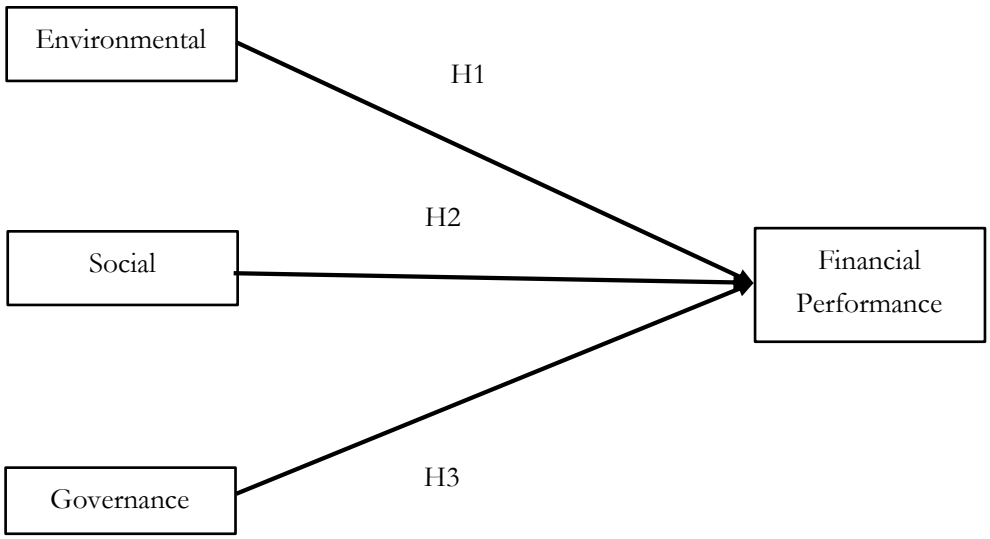

Figure 1. Research Model

3. Method

Based on the research objectives set by the researcher, namely testing and analyzing the relationship between ESG on company financial performance, the type of research for this research is a causal study.

The population in this research is all corporations listed on the Indonesia Stock Exchange with the research sample being companies listed on Kompas 100. The sampling technique used in this research is non-probability sampling with purposive sampling. The criteria used by researchers in taking samples are that companies registered in Kompas 100 must have complete E, S, and G value data from 2017 – 2022, must have had an IPO before 2017, and must have complete financial reports from 2017 until 2022. Based on these criteria, there are 21 companies listed in Kompas 100 that can be used as research samples with an observation period from 2017 to 2022.

The variables used in this research are the independent variables in the form of E score, S score, and G score obtained from the sustainability leadership monitor on Refinitiv, while the dependent variable is the company's financial performance which is proxied by ROE, ROA, and ROCE. The operational definition of this research variable can be seen in table 1.

This research uses panel data, the data collection technique uses archival data, namely a database and the data analysis use multiple linear regression technique if the data on the research variables are free from the classical assumption test, if the data is not free from the classic assumption test, then use the Spearman correlation test as an analysis technique of the data.

Table 1. Operational Definition of Variables

No	Research Variable	Formula	Measurement Scale
1	E (X_1)	Environmental scores are obtained from the Sustainability Leadership Monitor on Refinitiv	Ratio
	S (X_2)	Social value is obtained from Refinitiv's Sustainability Leadership Monitor	Ratio
	G (X_3)	Governance scores are obtained from the Sustainability Leadership Monitor on Refinitiv	Ratio
2	Financial Performance (Y)	ROE = Net Income / Total Equity ROA = Net Income / Total Assets ROCE = EBIT / (Current Assets – Current Liabilities)	Ratio

Source: Researcher Observation Results

4. Results and Discussion

Results

Independent variables: E, S, G, and dependent variable: ROE. The results of the classical assumption test can be shown in table 2.

Table 2. Classic Assumption Test Results

Types of Classical Assumption Tests	Results	Decisions
Normality test	Asymp. Sig (2-tailed) = 0.000	The data is not normally distributed because the Asymp.Sig value (2-tailed) ≤ 0,05.
Transformation of research data was carried out by natural logarithms of all research data.		
Normality test	Asymp.Sig (2-tailed) = 0.203	Transformed data has a normal distribution because the Asymp.Sig (2-tailed) value > 0.05.
Heteroscedasticity test	Sig for LN(E)= 0.793 Sig for LN (S) = 0.985 Sig for LN (G) = 0.317	Research variables are free from heteroscedasticity because of the Sig value (P-Value) > 0.05.
Multicollinearity test	VIF for LN(E) = 1.721 Tolerance for LN(E) = 0.581 VIF for LN (S) = 1.736 Tolerance for LN (S) = 0.576 VIF for LN (G) = 1.598 Tolerance for LN (G) = 0.626	The research variables are free from multicollinearity because the VIF value is < 10 and the Tolerance value is > 0.01.
Autocorrelation test	Asymp.Sig (2-tailed) = 0.000	Data is subject to autocorrelation due to Asymp.Sig (2-tailed) value ≤ 0.05.

Source: SPSS Processed Results

Table 3. Results of Research Hypothesis Testing

	Results	Decisions
LN (E) → LN (ROE)	Sig (2-tailed) = 0.001	H_1 is Accepted
LN (S) → LN (ROE)	Sig (2-tailed) = 0.050	H_2 is Accepted
LN (G) → LN (ROE)	Sig (2-tailed) = 0.874	H_3 is Rejected

Source: SPSS Processed Results

Table 2 shows that the research data does not pass the classical assumption test because the research data is subject to autocorrelation. Therefore, researchers used the Spearman correlation test as a method for testing research hypotheses and the outcome can be viewed in table 3. Table 3 describes:

- The first research hypothesis (H1) is accepted because the P-value ≤ 0.05, meaning there is a relationship between environmental (E) and ROE.
- The second research hypothesis (H_2) is accepted because P-value ≤ 0.05 means there is a relationship between social (S) and ROE.
- The third research hypothesis (H_3) was rejected because the P-value > 0.05, meaning there is no relationship between governance (G) and ROE.

Independent variables: E, S, G, and dependent variable: ROA. The results of the classical assumption test can be viewed in table 4.

Table 4. Classic Assumption Test Results

Types of Classical Assumption Tests	Results	Decisions
Normality test	Asymp.Sig (2-tailed) = 0.418	The data is normally distributed because of the Asymp.Sig (2-tailed) value > 0.05.
Heteroscedasticity test	Sig for E = 0.000 Sig for S = 0.388 Sig for G = 0.683	Variable E is subject to heteroscedasticity because the Sig value (P-Value) ≤ 0.05
The research data was transformed using the natural logarithm of all research data.		
Normality test	Asymp.Sig (2-tailed) = 0.297	The transformed data has a normal distribution because of the Asymp.Sig (2-tailed) value > 0.05.
Heteroscedasticity test	Sig for LN (E) = 0.279 Sig for LN (S) = 0.034 Sig for LN (G) = 0.139	The LN (S) variable is subject to heteroscedasticity because the Sig value (P-Value) ≤ 0.05.

Source: SPSS Processed Results

Table 5. Results of Research Hypothesis Testing

	Results	Decisions
LN (E) → LN (ROA)	Sig (2-tailed) = 0.006	H_1 is Accepted
LN (S) → LN (ROA)	Sig (2-tailed) = 0.241	H_2 is Rejected
LN (G) → LN (ROA)	Sig (2-tailed) = 0.048	H_3 is Accepted

Source: SPSS Processed Results

The outcome of the classical assumption test shown in table 4 state that the research data is not free from classical assumptions because there is heteroscedasticity in the research variable LN (S), so that researcher used the Spearman correlation test to test the research hypothesis, the outcome of which can be noticed in table 5. Table 5 explains that:

- The first research hypothesis (H_1) is accepted because the Sig value (2-tailed) or P-value ≤ 0.05 means there is a relationship between environmental (E) and ROA.
- The second research hypothesis (H_2) was rejected because the P-value > 0.05, meaning there is no relationship between social (S) and ROA.
- The third research hypothesis (H_3) is accepted because P-value ≤ 0.05 means there is a relationship between governance (G) and ROA.

Independent variables: E, S, G, and dependent variable: financial performance measured by ROCE. The results of the classical assumption test can be viewed in table 6.

Table 6. Classic Assumption Test Results

Types of Classical Assumption Tests	Results	Decisions
Normality test	Asymp. Sig (2-tailed) = 0.000	The data is not normally distributed because the Asymp.Sig value (2-tailed) ≤ 0.05.
Transformation of research data was carried out by natural logarithms of all research data.		
Normality test	Asymp.Sig (2-tailed) = 0.235	Transformed data has a normal distribution because the Asymp.Sig (2-tailed) value > 0.05.
Heteroscedasticity test	Sig for LN (E) = 0.016 Sig for LN (S) = 0.331 Sig for LN (G) = 0.768	The LN (E) variable is subject to heteroscedasticity because the Sig value (P-Value) ≤ 0.05.

Source: SPSS Processed Results

Table 7. Results of Research Hypothesis Testing

	Results	Decisions
LN (E) → LN (ROCE)	Sig (2-tailed) = 0.000	H_1 is Accepted
LN (S) → LN (ROCE)	Sig (2-tailed) = 0.302	H_2 is Rejected
LN (G) → LN (ROCE)	Sig (2-tailed) = 0.885	H_3 is Rejected

Source: SPSS Processed Results

The outcome of the classical assumption test in table 6 explain that the research variables are not free from classical assumptions because the research variable LN (E) is subject to heteroscedasticity, so that researchers use the Spearman correlation test to test the research hypothesis. The results of research hypothesis testing can be recognized in table 7. Table 7 describes that:

- The first research hypothesis (H1) is accepted because the Sig value (2-tailed) or P-value ≤ 0.05 means there is a relationship between environmental (E) and ROCE.
- The second research hypothesis (H2) was rejected because the P-value was > 0.05, meaning there was no relationship between social (S) and ROCE.
- The third research hypothesis (H3) is accepted because P-Value > 0.05, meaning there is no relationship between governance (G) and ROCE.

Discussions

Research hypothesis 1 (H1): The environment has a relationship with financial performance

Based on the outcome of research hypothesis testing in table 3, table 5, and table 7, it shows that the environment has a relationship with financial performance as valuated by

ROE, ROA, and ROCE. The results of this study were supported by research conducted by [16], [1], [17], [18], [22], and [23].

The outcome of this study indicate that the sample company has paid attention to its environment well and has carried out environmental maintenance such as waste management from production results, reducing the use of plastic and paper materials in conducting transactions and providing information to consumers. For example, transactions conducted by banks that suppress paper use to convey information and replace them by using e-mail in the delivery of banking information to consumers.

Active environmental management will have a positive impact on the corporation's reputation in the eyes of consumers, investors and other stakeholders so that it can indirectly have an impact on the corporate's financial performance in the future.

Research hypothesis 2 (H2): Social has a relationship with financial performance.

Table 3 shows social has a relationship with the financial performance calculated by ROE. The results of this study were supported by research conducted by [1].

The relationship between social and ROE illustrates that the sample company has carried out its operational activities effectively, especially related to the productivity of assets to generate income so that the sample company can obtain good financial performance with an increase in ROE value.

Table 5 and table 7 show that social has no relationship to financial performance as calculated by ROA and ROCE. The results of this research were supported by research by [4], [19], [15], and [23].

This shows that the sample companies have carried out a commitment to create products that provide added value, have made creativity in the management of company assets to create competitive advantage but all of them need a long process and time to be able to have an impact on financial performance, especially ROA and ROCE.

Therefore, if financial performance is to be measured in the short term, the impact of the company carrying out activities related to this social pillar cannot yet be fully reflected. This statement is supported by [24] who revealed that implementing the ESG program will have a long-term impact. This is thought to be why the social pillar has no relationship with financial performance as calculated by ROA and ROCE.

Research hypothesis 3 (H3): Governance has a relationship with financial performance.

Table 5 shows that governance has a relationship with financial performance as measured by ROA. The outcome of this study are supported by the finding from [16], [1], [18], and [22].

The relationship between governance and financial performance measured by ROA illustrates that the sample companies have paid attention to decision-making procedures, the behavior of the board of directors, and the corporate's organizational system and structure. Having good governance can increase the trust of stakeholders which has an impact on financial performance as calculated by ROA.

The outcome of testing the third research hypothesis is different in table 3 and table 7, where table 3 and table 7 show that governance has no relationship with financial performance as valuated by ROE and ROCE. These results are supported by research conducted by [4], [17], and [21].

This illustrates that the sample companies have implemented governance, but its implementation does not necessarily have an impact in the short term and cannot improve financial performance immediately. This statement is supported by [21] which states that the application of governance cannot increase the profit immediately so that companies must continue to apply governance to keep the company grow and survive so that it can improve financial performance in the long run.

5. Conclusions

Based on the research results, the conclusion obtained is that the environment has a relationship with financial performance as calculated by ROA, ROE, ROCE. Social has a relationship with financial performance as valuated by ROE but has no relationship with financial performance as calculated by ROA and ROCE. Governance has a relationship with financial performance as calculated by ROA but has no relationship with financial performance as valuated by ROE and ROCE.

With the relationship between the environment and financial performance, the practical implications that can be carried out by the sample companies are that in the short term the sample companies must make greater efforts to prevent environmental pollution, utilize renewable energy, carry out reforestation to create a cool, beautiful environment, as well as preventing landslides, and other things that can protect the environment.

The existence of a relationship between social and financial performance as calculated by ROE has practical implications in the form of sample companies' efforts to foster social relationships with the local community where the company is established, such as paying attention to the community, creating products that provide added social value for consumers, and getting involved in social activities.

Corporate governance also has a relationship with financial performance so that the practical implications that sample companies can pursue in this relationship are in the form of transparency of sample companies in all matters including clarity in providing information to stakeholders, employees, consumers and the wider community.

There are still very few corporations listed on the IDX that implement ESG consistently from 2017 to 2022 and many studies in Indonesia examine corporate social responsibility (CSR), while there is still little research on ESG in Indonesia where CSR is different from ESG, which the whole is a limitation in this study.

Suggestions that can be given are related to the results of this research, namely that companies should be able to implement E, S, and G well to create competitive advantages and survive in business competition in the long run. For future researchers, this research still needs to be researched using a different type of company, a longer period, and not only focusing on financial performance but also focusing on investment returns and the company's capital structure.

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