THE MEDIATING ROLE OF FINANCIAL PERFORMANCE IN ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) AND FIRM VALUE

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Abstract

Background: As global awareness begins to lead to sustainable business practices, the Environmental, Social, and Governance (ESG) framework becomes one of the important things in evaluating firms. Sustainability information such as ESG is considered capable of influencing firm value.
Objective: The goal of the study is to examine the effect exerted by ESG on the value of the firm with financial performance acting as a mediating variable.
Research Method: This study utilizes regression data analysis techniques to test the influence between variables. Secondary data were used in this study using Thomson Reuters and OSIRIS databases. The sample obtained was 35 firms that fit the purposive sampling criteria, with the number of observations for the 2017-2022 period being 210 observations.
Research Results: ESG cannot affect firm value, while ESG can affect financial performance, and financial performance can affect firm value. Results also show the full mediating effect exerted by financial performance on the connection between ESG and firm value.
Research Originality/Novelty: A research construct that uses financial performance mediation in explaining the connection between ESG and firm value.
Keywords: ESG; Financial Performance; Firm Value

Introduction

The overall assessment of the firm and its future growth potential will be reflected in the firm value. Values can serve as a guide or compass for investors and other stakeholders in terms of real measures of firm financial health, financial performance, and position in the market. In general, a firm's value can be expressed through market capitalization and book value, which summarize the valuation of a firm's assets, liabilities, and earnings potential. (Heliani et al., 2023; Ross et al., 2010; Utami et al., 2023; Utari et al., 2021). The important thing to note is that assessments tend to be dynamic and affected by various factors, both inside and outside of the firm. Based on this, it is known that understanding firm value is essential, because it is related to the long-term survival of the firm, provides attraction for stakeholders, and is able to create value for firm shareholders. (Utami et al., 2023).

There are several scandals that have affected the assessment of firms. Several scandals such as financial manipulation at Garuda Indonesia, Hanson International, and Envy Technologies Indonesia harmed market trust in corporate governance (CNBC Indonesia, 2021; IDX Channel, 2023), then the case of manipulation of product safety tests carried out by Daihatsu which affected Astra Indonesia and affected public trust in the firm (CNBC Indonesia, 2024), another scandal related to Chevron Pacific Indonesia, which was faced with public pressure regarding environmental issues like waste management and the impact of exploitation of natural resources (Energy World, 2022; Tempo, 2021). Several of these cases show that poor corporate governance and environmental problems can cause a decline in firm value in the eyes of stakeholders and the public. Overall, understanding and good handling of these problems is important to maintain and increase the market's assessment of the firm's value.

As global awareness leads to sustainable business practices, Environmental, Social, and Governance (ESG) frameworks are becoming important in firm evaluation. ESG is embodied in three pillars (environmental, social, and governance), where it goes beyond traditional financial metrics. The environmental pillar refers to the management of a firm's environmental impact, which can include a focus on areas such as carbon emissions, resource management, and ecological preservation. (Adeneye et al., 2022; Xu et al., 2021). The social pillar refers to the area of social responsibility, which evaluates a firm's engagement with employees, communities, and society as a whole (Adeneye et al., 2022; Liu & Lyu, 2022). Meanwhile, the governance pillar refers to the governance structure, examining issues such as board composition of directors, executive compensation, and ethical business conduct (Adeneye et al., 2022). The increasing consideration of ESG in valuations reflects a shift in the understanding of firm values that not only includes monetary benefits, but also includes broader social impacts and sustainable practices that include environmental, social, and corporate governance.

Sustainability information such as ESG is considered capable of influencing firm value (Aboud & Diab, 2017; Albitar et al., 2020; Chouaibi et al., 2022; Nguyen et al., 2022). Stakeholder theory can help explain this connection, where ESG-related information is a form of responsibility to the firm's stakeholders. ESG is a policy that pays attention to the environment, society, and governance, where by paying attention to these three aspects the firm can fulfill its obligations in a balanced manner to the parties included in stakeholders. (Fatemi et al., 2018). Thus, ESG disclosure will increase the trust of the public in the firm, then this will lead to an increase in the firm’s value.

A growing body of research is uncovering the interesting connection between ESG practices and firm values. Firms that demonstrate stronger ESG practices often have higher market valuations and increase the trust of stakeholders (Cardillo et al., 2023; Litvinenko et al., 2022; Nielsen & Noergaard, 2011). This phenomenon arises from a confluence of several factors. Firms that are aware of ESG practices are

seen as more resilient in facing changes or risks, such as pandemics (Broadstock et al., 2021; Kanamura, 2021). Additionally, firms tend to build stronger connections with stakeholders, resulting in brand loyalty and customer trust (Lee & Rhee, 2023; Puriwat & Tripopsakul, 2023; Sarpong et al., 2023). Empirical evidence provides a clear picture that firms committed to ESG principles are not only able to overcome challenges more effectively but can also thrive in the long term, ultimately increasing firm value.

The next thing that needs to be explained is how ESG practices can increase firm value. Financial performance has a very important intermediary role here. Financial performance metrics including profitability, ROA, and EPS can be a real reflection of a firm's operational efficiency (Wang et al., 2016). This ultimately means that the impact of ESG practices can be measured quantitatively. The measurability of ESG practices can be understood as the process of translating sustainability initiatives into tangible financial benefits. The point is that financial performance can be a translator of how ESG practices can contribute to increasing firm value, where firms with good ESG scores will experience increased good relations with customers and subsequently increase profitability (Aydoğmuş et al., 2022; Yunica & Rokhim, 2023). The increase that occurs in the firm's financial performance will then lead to an increase in firm value (Akhmadi & Januarsi, 2021; Pratiwi, 2020). This mediation provides an important analytical framework for understanding the connection between sustainability business practices such as ESG and the valuation of an enterprise. In simple terms, information regarding financial performance can be considered as a signal that a firm shares with its stakeholders. Signaling theory can explain how financial performance information can be captured by stakeholders, which is then translated into decision-making that affects firm value.

Previous research indicated that ESG can affect firm value (Albitar et al., 2020; Nguyen et al., 2022; Wong et al., 2021). However, different results indicate that ESG cannot affect firm value (Ainy & Barokah, 2019; Atan et al., 2018; Rastogi et al., 2023). The previous research also shows the effect of ESG on financial performance (Maji & Lohia, 2023; Nguyen et al., 2022; Pulino et al., 2022). However, different results also show that ESG practices have no effect on financial performance (Atan et al., 2018; Junius et al., 2020; Nisa et al., 2023). Likewise, the connection between financial performance and firm value shows opposite results. Several studies show a connection between financial performance and firm value (Akhmadi & Januarsi, 2021; Mudjijah et al., 2019; Rutin et al., 2019). However, several studies also show the opposite results (Kansil et al., 2021; Murni & Sabijono, 2018; Supriyadi & Setyorini, 2020). These different findings or inconsistent results mean that research on the influence of ESG on firm value with the mediating role of financial performance still requires further research.

Although the connection between ESG and firm values is well established, there are strong reasons to examine the mediating role of financial performance. This is based on the need to uncover the specific

mechanisms and flow of ESG practices in exerting their influence on firm value. By examining how ESG practices translate into financial results, we can understand how value is created and shareholder wealth is generated. Additionally, understanding the impact of this mediation is critical for firms seeking to align sustainability practices with long-term financial well-being. The motivation for this research is aim to explain the interaction between ESG, financial performance, and firm value to increase understanding of sustainable value creation in firms. Looking at its theoretical contribution, it is hoped that this research can verify stakeholder theory and signaling theory and help provide answers to contradictions in previous research results. Then, the research is also expected to give benefits for investors and other stakeholders in assessing a firm, so that it can support their decision making.

Literature Review

Stakeholder theory is an organizational theory, where the science of organizations is based on the implicit postulate of the individual-group-society-firm-organization-institution-state continuum (Pesqueux & Damak-ayadi, 2005). Stakeholders can be divided into several groups, there are parties who are directly related to firm operations and there are also parties who are not directly involved with firm operations but feel the impact. Mallin (2019) explains several stakeholder groups, namely shareholders, employees, creditors, suppliers, customers, communities, environmental groups, and government. Through this theory, by paying attention to the interests and needs of the various parties involved, firms can build a strong foundation for long-term growth and sustainability due to trust from stakeholders, good reputation, support from consumers, sustainable investors, and so on. In the end, it will help stakeholders in decision-making.

Signaling theory is a concept that describes the interaction between two parties, namely the signal sender and the signal recipient, where in this situation the sender has an important role in determining whether and how they will convey information through signals and so on. Meanwhile, the signal receiver has a role in interpreting or understanding the meaning of the signal given by the signal sender (Connelly et al., 2011; Spence, 1973). The signaling theory used in this research is based on the argument that this theory can explain firms as senders of signals to external parties to the firm, such as investors and shareholders. The information asymmetry that should arise between owners and management can be suppressed by the information provided to various parties outside the firm by managers.

ESG is basically still related to Corporate Social Responsibility, where ESG seeks to balance the environmental, social, and governance pillars as a sustainability initiative. ESG can promote firm value by reducing the capital cost of the firm and contributing to economic and social development which will ultimately provide a good reputation for the firm, thereby increasing firm value (Liu & Lyu, 2022; Wong

et al., 2021). Based on stakeholder theory, improvements in ESG practices are assumed to have an impact on increasing the interest of stakeholders such as investors, where ESG practices are assumed to be seen as a form of corporate responsibility towards these stakeholders, which is reflected in the increase in firm value in the market. Several studies explain that ESG positively affects firm value (Albitar et al., 2020; Nguyen et al., 2022; Wong et al., 2021). Based on those explanations, the following hypotheses are proposed:

H_1: ESG positively affects firm value

The concept of ESG practices in firms can be transformed into increasing firm profitability. Firms that adopt ESG practices are able to reduce the cost of capital of the firm (He et al., 2022; Jang et al., 2020), the good reputation gained from ESG practices will attract customers and investors, and sustainable practices can reduce long-term operational costs which then have an impact on increasing firm profitability. Based on stakeholder theory, the increase in ESG practices provides guidance that firms are responsible for all stakeholders by running the firm as well as possible through the adoption of Good Corporate Governance which affects the efficiency of the firm's operational costs which will be visible on increased financial performance. Several studies explain that ESG positively affects financial performance (Maji & Lohia, 2023; Nguyen et al., 2022; Pulino et al., 2022). Based on those explanations, the following hypotheses are proposed:

H_2: ESG positively affects financial performance

Financial performance basically shows the level of good and correct financial implementation within the firm in accordance with existing regulations (Umar et al., 2020). Financial performance is generally assessed using profitability indicators, which show the efficiency of the firm in financial management and the ability of the firm to generate profits (Suryasari & Artini, 2020). When this value increases, the existing demand for firm shares will increase, which is directly proportional to the increase in firm value. Relies on signaling theory, an increase in financial performance as proxied by profitability will cause an increase in market trust which will be reflected in an increase in firm value. Several studies explain that financial performance positively affects firm value (Akhmadi & Januarsi, 2021; Mudjijah et al., 2019; Rutin et al., 2019). Based on those explanations, the following hypotheses are proposed:

H_3: Financial performance positively affects firm value

The connection between ESG and firm value still requires further research regarding how ESG can influence firm value. Financial performance with profitability indicators is considered capable of explaining how ESG mechanisms can influence firm value. Stakeholder theory and signaling theory are used to explain

this connection, when a firm can carry out ESG practices well, then the firm has demonstrated its responsibility to stakeholders which is able to lower the cost of capital and enhance the firm profitability. Then the increase in firm profitability will be reflected in an increase in firm value because of positive signals received by the market. Previous research shows that ESG positively affects financial performance (Maji & Lohia, 2023; Nguyen et al., 2022; Pulino et al., 2022) and financial performance positively affects firm value (Akhmadi & Januarsi, 2021; Mudjijah et al., 2019; Rutin et al., 2019). Based on those explanations, the following hypotheses are proposed:

H_4: Financial performance mediates the connection between ESG and firm value.

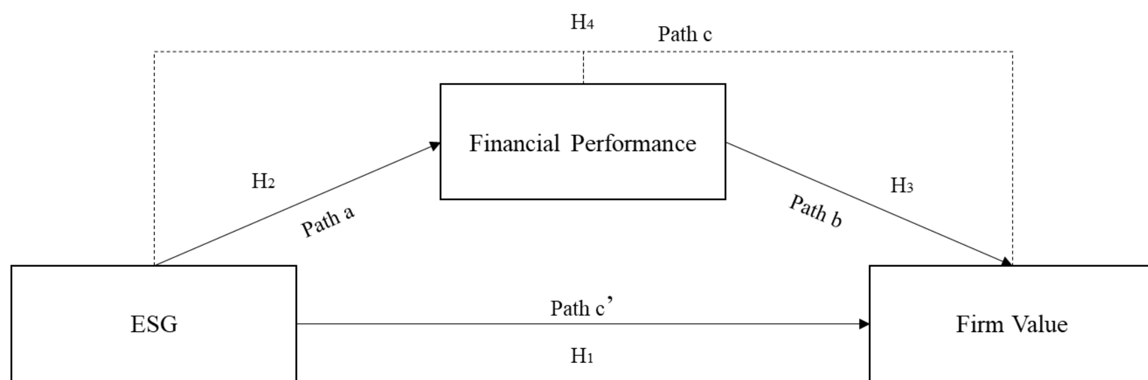

Figure 1. Research Model

Research Methods

This research uses a quantitative research approach. The data related to this research comes from the Thomson Reuters Database for ESG data and the Osiris Database for financial performance and firm value data. The firms included in this research population are all non-financial firms listed on the IDX for the 2017-2022 period whose data is available on the Thomson Reuters Database. The sample for this research is determined using a purposive sampling technique, which has criteria including (1) being listed on the IDX consistently during the 2017-2022 period, (2) not being registered as a financial firm, (3) the firm consistently having complete information related to ESG, financial performance, and firm value during the 2017-2022 period. Based on this sampling technique, 35 firms were obtained for each year that met the criteria, thus the total number of observations is 210 firm years.

Then, regarding the measurement of each variable involved in this research, it can be explained in Table 1 below.

Table 1. Variable Measurement

Variable	Proxy	Measurement	Reference
ESG	Thomson Reuters ESG Score	Environmental Indicator Score + Social Indicator score + Governance Indicator Score	(Thomson Reuters Eikon, 2017)
Financial Performance	Return on Assets (ROA)	$\frac{\text{Net Profit}}{\text{Total Assets}} \times 100\%$	(Adikerta & Abundanti, 2020)
Firm value	Price to Book Value (PBV)	$\frac{\text{Market Value per Share}}{\text{Book Value per Share}}$	(Ross et al., 2010)

Then the data analysis process used in this research consists of (1) a test of descriptive statistics, which is useful for describing a summary of the data in this research; (2) test of coefficient of determination, which is useful for finding out how much the research independent variable can explain the dependent variable in this research; and (3) hypothesis testing, which is useful for making decisions regarding accepting or rejecting the proposed hypothesis. Hypothesis testing in this research used the Hayes PROCESS Macro in the SPSS program to carry out hypothesis testing. In this case, PROCESS Macro model 4 is used to test the direct connection between the independent variable and the dependent variable, as well as to test the mediating effect of the mediating variable on the connection between the independent variable and the dependent variable (Hayes, 2022). The testing option using Hayes' PROCESS Macro was chosen because it allows to test of each connection between variables in one test, including mediation effects (Hayes, 2022). Below is presented the regression equation used in this research:

$$\mathrm{ROA}_{i,t} = \alpha + \beta_1 \mathrm{ESG}_{i,t} + \varepsilon_{i,t} \tag{1}$$

$$\mathrm{PBV}_{i,t} = \alpha + \beta_2 \mathrm{ESG}_{i,t} + \beta_3 \mathrm{ROA}_{i,t} + \varepsilon_{i,t} \tag{2}$$

Information:

α = Constant
β1-3 = Regression Coefficient 1-3
i,t = sample and year of firm
ε = Error
ROA = Return on Assets (Mediation Variable)
PBV = Price to Book Value (Dependent variable)
ESG = Environmental, Social, and Governance (Independent Variable)

Results and Discussion

Statistical Test Results

Table 2. Descriptive Statistical Test Results

Variable	N	Min.	Max.	Mean	Std. Deviation
PBV	210	0.17	66.40	3.86	7.59
ESG	210	10.68	85.28	48.54	18.59
ROA	210	-16.63	55.73	8.74	9.67

Referring to the descriptive statistics table above, the results show the smallest value, largest value, average, and standard deviation of variables in this research. PBV with the smallest value was 0.17 by ANTM in 2017, the largest value was 66.40 by UNVR in 2017. Then the average PBV for the 2017-2022 period is 3.86 with a standard deviation of 7.59. ESG with the smallest value was 10.68 by CPIN in 2017, the largest value was 85.28 by ITMG in 2017. Then the average ESG for the 2017-2022 period is 48.54 with a standard deviation of 18.59. ROA with the smallest value is -16.63 by LPKR in 2020, the largest value is 55.73 by ITMG in 2022. Then the average ROA for the 2017-2022 period is 8.74 with a standard deviation of 9.67.

Table 3. Coefficient of Determination Test Results

Equation	R	R^2
Equation 1	0.25	0.60
Equation 2	0.60	0.36

Based on the test results in Table 3, the R^2 value for Equation 1 is 0.60 and Equation 2 is 0.36. This shows that in equations 1 and 2, the independent variables can explain the dependent variable by 60% and 36% respectively. This is still within reasonable limits considering that there are a lot of other factors remaining that can influence financial performance and firm value, both internal and external to the firm. This opens further research opportunities in the future.

Table 4. Regression Test Results

Regression Variables	Coefficient	p
ESG on ROA (path a)	2.5230	0.0000
ROA on PBV (path b)	0.4649	0.0000

Regression Variables	Coefficient	p
ESG on PBV (path c')	0.0180	0.4412
ESG on PBV through ROA (path c)	0.0776	0.0058

Based on the results of the regression test in Table 4, financial performance as a mediator can mediate the connection between ESG and firm value, which can be included in the full mediation type. A more detailed explanation of the connection between each variable will be explained in the following section.

The Effect of ESG on Firm Value

Based on the test results in Table 4, the connection between ESG and firm value has a coefficient of 0.0180 and a p-value of 0.4412. This shows that ESG is unable to have a positive effect on firm value as proxied by PBV ($p > 0.05$), so H_1 is rejected. These results illustrate that an increase in the ESG score is not able to provide an increase in firm value. ESG-related information is still not able to increase firm value in Indonesia, this can be caused by a lack of stakeholder interest in ESG-related information so that it does not significantly affect firm value.

The research results do not support the stakeholder theory, where ESG information is not fully responded to by stakeholders as a form of corporate responsibility, so it does not provide added value to the firm's image in the market which causes the firm value to not experience a significant increase. ESG is basically considered unable to increase firm value, where they have the same market value, so firms that have ESG information more or less have the same value and are also bad. (Atan et al., 2018). This study's result or finding is in line with previous research that has been conducted by Ainy & Barokah (2019), Atan et al. (2018), and Rastogi et al. (2023), where ESG cannot affect firm value.

The Effect of ESG on Financial Performance

Based on the test results in Table 4, the connection between ESG and financial performance has a coefficient of 2.5230 and a p-value of 0.0000. This shows that ESG can positively affect financial performance as proxied by ROA ($p<0.05$), so H_2 is accepted. These results illustrate that increasing the ESG score can improve financial performance. When ESG increases by 1 it will increase financial performance by 2.5230. The positive value in the coefficient of the connection between ESG and financial performance as proxied by ROA can occur due to factors such as the firm's focus on corporate governance and social aspects. This is often associated with financial success which tends to be better as a result of implementing practices that are responsible for the environment (Pulino et al., 2022).

Although the initial costs of investing in ESG practices are expensive, this will be offset by the benefits that will be obtained later. A significant increase in ROA can certainly be realized in the long term even though it requires a fairly high initial investment (Nguyen et al., 2022), This is reflected in the sample firms in this research, where the firms included in the sample are firms that consistently implement ESG practices during the 2017-2022 period.

Our result supports stakeholder theory, the increase in ESG practices provides an indication that firms are responsible for all their stakeholders by running the firm as well as possibly by implementing good governance. This will affect the efficiency of the firm's operational costs, which will then improve the firm's financial performance, resulting in a reduction in operational costs. This study's result or finding is in line with previous research that has been studied by Maji & Lohia (2023), Nguyen et al. (2022), and Pulino et al. (2022).

The Effect of Financial Performance on Firm Value

Based on the test results in Table 4, the connection between financial performance and firm value has a coefficient of 0.4649 and a p-value of 0.0000. This shows that financial performance as proxied by ROA positively affects firm value as proxied by PBV ($p<0.05$), so H_3 is accepted. These results illustrate that an increase in financial performance value can increase firm value. When financial performance increases by 1 it will increase firm value by 0.4649. A positive value in the coefficient of the connection between financial performance and firm value as proxied by PBV can occur because basically when financial performance improves as reflected in increasing firm profitability, the market assessment of the firm will increase too. The firm profitability reflects the level of net profit that the firm is able to obtain in carrying out its operations so that when net profits tend to be high, this will have an impact on increasing the profits that will be distributed and be able to provide added value for the firm's investors (Rutin et al., 2019).

Our research supports the signaling theory, in this terms, the signal of increased financial performance which is reflected in profitability as proxied by ROA provides an indication that the firm is able to generate profits from good asset management (Mudjijah et al., 2019), this signal is then captured by external parties such as investors and has a positive effect. ROA can provide a signal to external parties of the firm which is reflected in an increase in firm value. This study's result or finding is in line with previous research that has been studied by Kansil et al. (2021), Murni & Sabijono (2018), and Supriyadi & Setyorini (2020).

The Effect of ESG on Firm Value Through Financial Performance

Based on the test results in Table 4, financial performance can mediate the connection between ESG and firm value with a coefficient value of 0.0776 and a p-value of 0.0058, so that H_4 is accepted. Refers to Baron & Kenny (1986), with the existence of Path A and Path B which are significant, it can be said that there is a mediating role given by financial performance to the connection between ESG and firm value. Path c' is not significant, but Path A and Path B have significant value, thus the financial performance's role can be said to be full mediation. Financial performance can help explain the connection that exists between ESG and firm value. When ESG improves, it is not directly reflected in an increase in firm value. ESG will help improve the firm's ability to generate profits through good corporate governance and will be a form of corporate responsibility towards its stakeholders, this is visible in the increase in the financial performance value of the firm as proxied by ROA (Pulino et al., 2022). Then, an increase in financial performance (ROA) as an impact of investment in ESG practices will encourage an increase in market assessment of the firm, where an increase in firm profits is a good signal for external parties such as investors. This signal will be captured by investors and then reflected in increasing firm value (Murni & Sabijono, 2018).

The results obtained from this research indicate that there is full mediation provided by financial performance. The result is also supported by previous research findings. Previous research shows that ESG can affect firm value (Maji & Lohia, 2023; Nguyen et al., 2022; Pulino et al., 2022), and financial performance can affect firm value (Kansil et al., 2021; Murni & Sabijono, 2018; Supriyadi & Setyorini, 2020).

Theoretical Implications and Practical Implications

The results provided in this research give empirical evidence that proves stakeholder theory. ESG is an important factor for investors and other stakeholders, which shows that firms are responsible for running the firm as well as possible, by implementing good governance. Apart from that, this research also provides empirical evidence that proves the signaling theory. The signal of an increase in financial performance provides an indication that the firm can generate profits, where this signal is then captured by external parties such as investors and has a positive impact. In addition, the research results also add to the wealth of academic literature regarding how ESG mechanisms can increase firm value and how financial performance translates good ESG practices into increased firm value.

Looking at the practical implications, this research provides evidence of how ESG increases firm value through financial performance. Managers need to consider ESG practices in their efforts to increase firm value, by managing assets optimally through good governance practices to increase the trust of

investors and other stakeholders. In addition, the results also give a better understanding of the relevant information considered by investors and other stakeholders in assessing a firm. Through the mediating role of financial performance in the connection between ESG and firm value, investors can assess the firm's responsibility and commitment, so that these parties become more confident in investing their capital in the firm. For stakeholders, it is hoped that the research results presented above will be able to provide an overview of sustainability practices in firms in Indonesia, thereby enriching their assessment in the process of decision-making.

Conclusion

The test results show that ESG is unable to directly affect firm value. ESG positively affects firm financial performance and financial performance positively affects firm value. Based on these findings, it can be said that financial performance can mediate ESG with firm value, where the mediation effect that occurs is full mediation. These results show that when there is an increase in ESG practices, there will be an increase in firm efficiency which will be able to increase the net profit earned by the firm, then this will positively affect the market assessment of the firm which can be seen in the increased in firm value.

This research contributes by providing empirical evidence regarding the influence of sustainability practices such as ESG on firm valuation by looking at the mediating effect of firm financial performance. The research results also contribute to the verification of stakeholder theory on the connection between ESG and financial performance as well as signaling theory based on the influence of financial performance and firm value. Apart from that, the research results also provide benefits for investors and other stakeholders in assessing firms for decision-making.

This research is not free from various forms of shortcomings, such as the limited number of samples because data related to ESG practices in Indonesia is still limited and this research uses balanced data. The next limitation is related to measuring firm value, which focuses more on assessing historical costs, so it does not really reflect current value. Regarding suggestions, future research could consider using other ESG databases with a more diverse amount of data and consider using unbalanced and balanced panel data. Additionally, future research could consider using other measures of firm value that represent not only past value but also current value. Then, future research can also consider mediating variables other than financial performance in explaining the connection between ESG and firm value namely environmentally friendly innovation, financial distress, and so on.

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