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# THE EFFECTS OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) DISCLOSURES ON FINANCIAL PERFORMANCE: A THEORITICAL APPROACH

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***ABSTRAK***

*Tujuan dari penelitian ini adalah untuk memberikan preposisi pengukuran Environmental Social and Governance (ESG) terhadap kinerja keuangan perusahaan. Penelitian ini merupakan penelitian kualitatif dengan mengumpulkan data melalui survei literatur. Studi literatur adalah pendekatan untuk memecahkan masalah dengan meninjau literatur sebelumnya. Hasil dari penelitian ini menunjukkan bahwa perusahaan dapat menjadi lebih transparan dalam pelaporan keuangan dan kinerjanya jika perusahaan melakukan komitmen yang kuat terhadap Environmental Social and Governance (ESG) disclosure. Menurut pemangku kepentingan, ini adalah metode yang sangat baik untuk memberikan informasi yang jelas dan dapat dipertanggungjawabkan karena pengungkapan Environmental Social and Governance (ESG) perusahaan dianggap dapat meningkatkan kinerja keuangan perusahaan.*

***Kata kunci : Environmental, Social, Governance, ESG Disclousures, Financial Performance***

***ABSTRACT***

*The purpose of this study is to provide a preposition of Environmental Social and Governance (ESG) measurement on corporate financial performance. This research is a qualitative research by collecting data through literature survey. Literature study is an approach to solving problems by reviewing previous literature. The results of this study indicate that companies can become more transparent in their financial reporting and performance if they make a strong commitment to Environmental Social and Governance (ESG) disclosure. According to stakeholders, this is an excellent method to provide clear and accountable information because the company's Environmental Social and Governance (ESG) disclosure is considered to improve the company's financial performance.*

***Keywords: Environmental, Social, Governance, ESG Disclousures, Financial Performance***

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## I. INTRODUCTION

International forums still often talk about how companies implement environmental, social, and governance (ESG) principles. The many negative impacts on the environment that are feared to have a fatal impact around the world make the issue a major concern. The introduction of ESG aims to balance a company's profit orientation with social and environmental sustainability. There are evaluation factors that set the standard for companies to adopt ESG. It is a management strategy that focuses on environmental, social, and governance issues and the company's desire to improve its performance. (Velte, 2017)

Environmental, Social, and Governance (ESG) is a phrase used to describe the non-financial elements that impact a company's performance and reputation. ESG covers issues such as environmental protection, social responsibility, good governance practices, and information transparency (Shakil, 2021).

ESG disclosure is the process of providing stakeholders, including investors, customers, workers, regulators, and the general public, with information about a company's ESG performance. The goal of ESG disclosure is to give a more thorough and impartial view of a company's risks, values, and effects on the environment and society (Beir, 2020).

ESG disclosure is becoming increasingly important and relevant in an era of globalization and intense competition, and amid the challenges and opportunities posed by climate change, the health crisis, social inequality and technological innovation. A company's access to capital, market value, customer loyalty, sales growth, and operational efficiency can all be enhanced by ESG disclosure. Additionally, a company's cost of capital, legal risk, reputational risk, and operational risk can all be decreased by ESG disclosure (Bermejo et, al, 2021).

The ESG standards applied in Indonesia are a cause for concern. Indonesia ranks 36th in the world based on a ranking conducted by Corporate Knights. Other ASEAN countries are far below this position; the Philippines is 30th, Malaysia is 22nd, and even Thailand is already 9th. Indonesia, as a developing country trying to get out of the middle income trap, can utilise the pandemic situation as a momentum to accelerate the implementation of ESG in various aspects of development, one of which is infrastructure development.

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In Indonesia, investments grounded in the principles of ESG disclusure have demonstrated a noteworthy surge. The quantity of funds managed by ESG-themed mutual funds and exchange-traded funds (ETFs) and the number of products they offer have grown significantly since their launch in 2014.

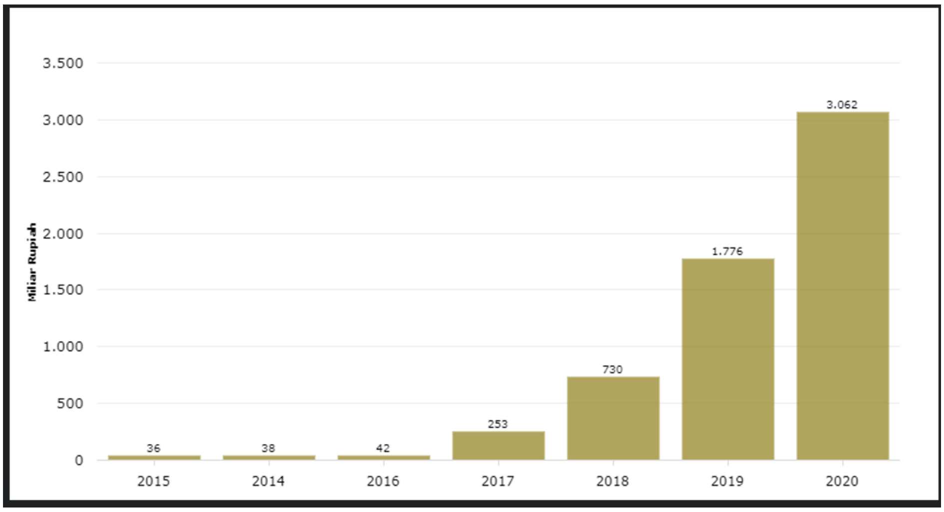


*Figure 1. Trends in ESG Investment in Indonesia*
*Source: Katadata (2021)*

Based on data compiled by the Financial Services Authority (OJK) as of December 2020, there were 14 ESG-based mutual fund and ETF products with an asset under management (AUM) value of IDR 3.062 trillion. This figure increased dramatically compared to a year earlier, which was around IDR 1.7 trillion with 10 products. This upward trend is a continuation of the previous years. In 2018, ESG-themed managed funds reached Rp 730 billion (seven products), in 2017 Rp 253 billion (2 products), in 2016 Rp 42 billion (2 products), and Rp 36 billion (1 product) in 2015.

The impact of environmental, social, and governance (ESG) practices on financial performance should be monitored and measured going forward because doing so can assist businesses in making the required adjustments and maximizing profits. Some businesses think that by cutting costs, environmental programs give them a competitive edge. They also think that by focusing on environmental, social, and governance (ESG) practices, businesses can improve their financial performance. (Chen and others, 2023). Businesses can make more accurate business assessments by

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taking into account ESG risk factors, and this will have an effect on the company's financial performance (Khorin & Krikunov, 2021)

Based on the background, conducting a literature review on ESG in improving financial performance can help companies as an important approach in presenting transparent and accountable information.

## II. LITERATURE REVIEW

### 2.1. Legitimacy Theory

The reason businesses frequently take social and environmental factors into account when conducting business is explained by legitimacy theory. By making sure that the business adheres to the social norms and values that are prevalent in its community, legitimacy theory seeks to establish the company's legitimacy with the community. Practices that enable the maintenance of legitimacy to achieve the company's goals must be put into place in order to implement a strategic legitimacy approach (Ali, et, al, 2022). The need to gain legitimacy drives the growth of corporate actions through ESG strategies (Eliwa, et, al, 2021). Similarly, companies that perform poorly on ESG aspects face difficulties in obtaining the resources and support necessary to succeed in their operating environment because legitimized ESG practices put the company on a favorable footing. (Xue, et, al, 2023). Companies are motivated to participate in ESG practices after convincing their stakeholders that they are committed to acting in accordance with societal norms and expectations. (Michelon, et, al, 2021)

Legitimacy theory offers several concepts about the effect of social responsibility involvement on financial performance and environmental reputation. (Bansal dan Clelland, 2004). Good ESG performance is necessary to enhance the legitimization process and reduce the company's reputational risk; consequently, companies are under-adopting ESG integration because they do not understand how to integrate ESG issues into financial performance and corporate strategy. (Bruna,et, al, 2022).

### 2.2. Stakeholder Theory

Stakeholder theory reveals that every business takes into account the interests of other parties in carrying out its operations. Other parties include suppliers, creditors, shareholders, employees, and members of the public who have a direct commercial relationship with the company. The position of stakeholders as people or groups involved in or receiving direct and indirect effects from the company's business activities, including social and environmental impacts, is highlighted by the theory of stakeholders (Freeman dan Dmytriyev, 2017).

According to this theory, a business's sustainability initiatives can strengthen its bonds with stakeholders and draw in new capital (Habib, et, al, 2023). Shareholders are parties who own shares in the company while parties who have an interest in the company's performance for reasons other than raising capital are called stakeholders. The policies taken by the company can affect or be affected by its business activities, so the company needs to pay attention and help its stakeholders. (He, et, al, 2023).

Companies that work to meet the needs and improve the welfare of their stakeholders will be able to run well because they will get support from internal and external stakeholders. Ultimately, stakeholders will appreciate the company's performance, which in turn will increase the company's value (Razak, et, al, 2023)

### 2.3. Signaling Theory

The practice of a company's management giving investors hints about how they perceive business prospects is known as signaling theory. This theory explains why businesses feel compelled to give external parties access to information about their financial statements.. (Bergh, et, al, 2023). Signagling theory can be used to communicate adherence to social values to an organization's various stakeholders (Cornelly, et, al, 2011).

One way companies promote themselves to suppliers, employees, consumers and others is by conducting signaling activities regarding environmental, social and governance (ESG) aspects. By doing so, the company tries to gain credibility and a good standing in the eyes of suppliers, employees, consumers, and investors, thus supporting the company's business activities. (Lee, et, al, 2023)

### 2.4. Environmental, Social, Governance (ESG)

Companies that plan to base their investments on environmental, social, and governance considerations should adhere to environmental, social, and governance (ESG) guidelines. ESG evaluates a company's investment's sustainability and social impact using measurement tools (Razak, et, al, 2023). The ESG assessment aspect is an investment practice standard for companies that

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integrate and execute their policies in a manner consistent with the concepts of environmental, social and governance (Wong, et, al, 2023).

Measurement, disclosure, and accountability to all stakeholders—both inside and outside the company—are the goals of this practice. The ESG score of a business indicates how well it is doing in relation to sustainable development objectives. The company's resource utilization, use of natural resources, human rights, level of corruption, investments in community relations, etc. are all covered in the ESG report. ESG reports are frequently examined by shareholders in relation to a company's efficacy, strength, and risk management. (Seker, 2021).

### 2.5. Financial Performance

A description of the financial state for components of fund collection and allocation over a specific time period is known as financial performance. These elements are typically gauged by indices of profitability, liquidity, and capital adequacy. (Tinjani, 2023). Financial performance is the company's achievement when carrying out business activities as measured by financial ratios (Thayaraj, 2021). There are various measures used in measuring a company's financial performance. The market-to-book value (MTBV), return on assets (ROA), asset turnover (ATO), return on equity (ROE), and Tobin's q (TOBINQ) ratios are used in accounting and finance research to gauge the performance of businesses.

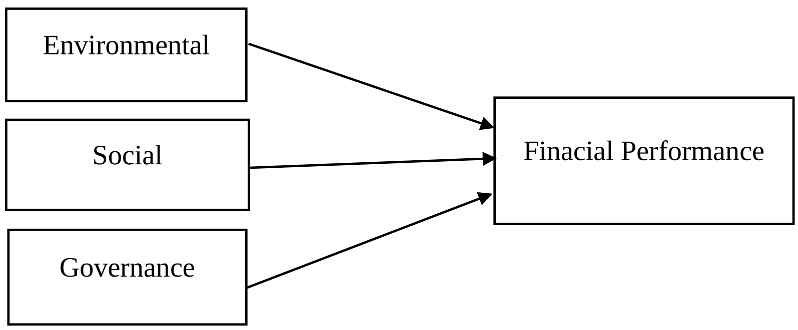


*Figure 2. Conceptual Framework of Research*

## III. RESEARCH METHOD

This research uses a qualitative method, which aims to provide a preposition of ESG measurement on the company's financial performance. The data collection technique in this research uses literature study, which is qualitative research with development derived from literature research that critically examines the knowledge, ideas, and theories that exist in the literature. literature study is research conducted by researchers by collecting a number of books, magazines related to research problems and objectives. The technique aims to reveal various theories that are relevant to the problems being faced / researched as reference material in discussing the research results. (Danial & Warsiah, 2009).

## 1V. RESULTS AND DISCUSSION

### 4.1. The Effect of Environment Disclosure on Financial Performance

Environmental problems occur every year. The influence of environmental factors varies greatly on all aspects related to it. Based on the results of research by (Razak, et, al, 2023) discovered a substantial and positive correlation between corporate financial performance and environmental performance. Strong environmental performance has the potential to boost financial performance and vice versa. Companies need to be aware of their stakeholders' demands regarding environmental performance in order to avoid having their financial performance and sustainability negatively impacted. Moreover, the same thing is disclosed by (Rizqi, et. al, 2023) Because it shows that the business has met its obligations and can prevent environmental damage issues that could result in higher costs or even the company's closure of its business operations, good environmental performance can be evidence that the business can grow sustainably and over the long term.

### 4.2. The Effect of Social Dixclousure on Financial Performance

The financial performance of the company is found to be positively and significantly impacted by social disclosure. This demonstrates that the company's social initiatives receive positive feedback from its stakeholders, which helps to streamline its business operations. The business is thought to have upheld the concept of responsible business conduct, which covers things like social policy, fair trade and consumer protection, human rights, science, and technology, as well as anti-corruption governance systems. (Martha, et, al, 2023) Through societal activities held by the company, ESG practices are legitimized and further place the company on a footing that benefits their business. Companies easily enjoy acquiring resources more efficiently and on more favorable terms (Singhania and Saini, 2022). The results of this investigation strengthen the body of evidence demonstrating the beneficial effects of socially responsible behavior on business value and performance (Fatemi et al., 2015; Malik, 2015). The results of this study also support other research showing that environmental, social, and governance (ESG) practices are a strength for businesses that have an impact on their financial performance. (Murashima, 2020; Wong et al., 2020).

**4.3. The Effect of Governance Disclousure on Financial Performance**

The results show This suggests that the company employs effective corporate governance procedures. One aspect of governance being examined is how business management directs and regulates its organizational authority. Ensuring that management runs consistently and that stakeholders receive all reports is the aim of governance. The reporting is in the form of financial statements and annual reports that contain important information for each stakeholder. The information presented by the company in the annual report and financial statements can be used by stakeholders to make decisions regarding the business run by the company. The findings of this study are in line with previous studies which report that environmental, social and governance (ESG) practices are a strength for companies that affect their financial performance (Murashima, 2020; Wong et al., 2020). Thus, through good corporate governance, it will produce relevant information, so that business decisions become appropriate in meeting the company's financial performance targets.that governance has a positive and significant impact on the company's financial performance. Based on the literature study, the use of variables can be summarised in the following table:

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| Author | Variable | Country | Results |
|---|---|---|---|
| **Razak, et, al (2023)** | Environment, social and governance (ESG), Financial Performance | Brunei Darussalam | Positive |
| **Rizqi, et, al (2023)** | Environment, social and governance (ESG), Financial Performance | Indonesia | Positive |
| **Martha, et, al (2023)** | Environment, social and governance (ESG), Coorporate Performance | Indonesia | Positive |
| **Singhania and Saini (2022)** | Environment, social and governance (ESG), Company Performance | India | Positive |
| **Ali, et, al (2022)** | Environment, social and governance (ESG), Financial Performance | Malaysia | Positive |
| **Baier, et, al (2020)** | Environment, social and governance (ESG), Financial Performance | Germany | Positive |
| **Chen, et, al (2020)** | Environment, social and governance (ESG), Financial Performance | China | Positive |
| **Eliwa, et, al (2021)** | Environment, social and governance (ESG), Financial Performance | United Kingdom (UK) | Positive |
| **He, et, al (2022)** | Environment, social and governance (ESG), Financial Performance | China | Positive |
| **Khorin, et, al (2021)** | Environment, social and governance (ESG), Financial Performance | Russia | Positive |

*Table 1. Summary of Literature Review*
*Source: Researcher Processed Data (2023)*

## V. CONCLUSION AND RECOMMENDATION

This research explains the significance of environmental, social, and governance (ESG) practices for enhancing the performance of businesses. The study's conclusions show that the company's efforts to participate in environmental initiatives are still not well received by stakeholders, including creditors, investors, the government, and the general public. As a result, the company's financial performance is not affected. This study demonstrates how the company's dedication to social responsibility exemplifies the high standard of ethical behavior in managing the business, thereby enhancing the financial performance of the organization. This is considered by stakeholders as an important approach in presenting transparent and accountable information. Therefore, the company's ESG disclosure is considered to be able to improve the company's financial performance.ESG disclosure is considered to be able to improve the company's financial performance. The limitation of

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this research is that it only presents in the form of a literature study. For further research, it can conduct data analysis and testing with the variables used in this study.

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