



The effect Of ESG disclosure on firm's performance in manufacturing and banking companies

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Abstract

This research aims to examine the influence of ESG Disclosure on Firm's Performance. The variables used in this research are ESG Disclosure as an independent variable; operational performance, financial performance & market performance as dependent variables; and leverage & firm size as control variables.

This research uses samples of manufacturing and banking companies listed on the Indonesia Stock Exchange in 2019-2021. The sampling technique that is used in this research is purposive sampling with a certain criteria to obtain a sample of 150 samples. The data analysis method used Partial Least Square (PLS) with WrapPLS software version 8.0 as a supporting application.

The research results show that ESG Disclosure has a significant positive influence on operational performance, financial performance and market performance in manufacturing companies. Meanwhile, in banking companies, ESG Disclosure has a significant negative influence on operational performance and financial performance, but a significant positive influence on market performance.

Keywords: ESG score, ESG disclosure, operational performance, financial performance, market performance

Introduction

Environmental, social and governance performance or what is known as environmental, social and governance (ESG) has become a standard for assessing global corporate social responsibility in recent years. The United Nations Principles of Responsible Investment report, which encourages the integration of ESG elements into sustainable investment practices, has drawn attention to these ESG issues.

Companies are starting to place hope and attention on environmental, social and governance issues which can attract investors to make socially responsible investment decisions (De Lucia *et al.*, 2020). Investors are starting to realize that if companies ignore ESG performance it will have a negative impact on company performance. Along with the development of science and technology and the level of environmental awareness in various countries, including Indonesia, the industrial transformation 4.0, according to Chasbiandani *et al* (2019), has had an impact on changing the perspective, from the interests of shareholders to the interests of stakeholders.

The Indonesian government issued Law (UU) on Limited Liability Companies no. 40 Article 74 of 2007 for companies to carry out Corporate Social Responsibility (CSR). The government also issued Government Regulation Number 59 of 2017 as a commitment to achieving sustainable development goals. In the same year, the government also issued Financial Services Authority Regulation (POJK) No.51/POJK.03/2017 to enforce sustainable financial practices among financial services institutions, issuers and public companies. Things that must be done regarding Corporate Social Responsibility (CSR) according to the law (UU), namely programs containing CSR are required by companies to be oriented and aligned with sustainable development as mandated in the 1945 Constitution.

Several cases that occurred in Indonesia, such as the Lapindo mud in Sidoarjo caused by Lapindo Brantas Inc

and the mining area in Papua from PT Freeport Indonesia with the problem of empowering tribal communities, are one proof of the pollution from environmental damage experienced by the community.

ESG disclosure in Indonesia is starting to become popular, marked by companies starting to disclose ESG in their corporate sustainability reports. This is supported by the IDXESGL30 index which was determined on December 14, 2020, which is a combination of strategic initiative indices to strengthen sustainable investment in the Indonesian capital market. However, the implementation of ESG in Indonesia is currently still in a progressive stage because it cannot yet be applied to all companies. Not a few companies have not been able to implement the concept of sustainability or disclose information about this concept to the public domain.

According to research conducted by Amina Buallay (2019), ESG provides an explanation that positively influences operational, financial and market performance in the manufacturing sector, which shows that green production does not have high costs compared to the results. However, ESG has a negative impact on operational, financial and market performance in the banking sector where it is still very far from adopting appropriate sustainability policies in line with those that impact operational performance and investor confidence in a positive way.

According to other research conducted by Hesti Kirana Dwindi Putri (2021), environmental disclosure has a positive impact on company value, social disclosure has a negative impact on company value, and governance disclosure does not have a significant impact on company value. The research results show that it helps company management consider operational sustainability issues and helps investors make investment decisions.

The manufacturing and banking sectors were chosen in this research because the manufacturing sector is a sector that is an indicator of a country's progress because it is able to

meet domestic needs and is able to compete with other countries in the economic sector, while the banking sector is the largest sector that provides funds for growth. country's economy.

Based on research conducted by Kurnaiwan (2017), it is explained that based on data from the United Nations Industrial Development Organization (UNIDO) in 2018, it showed an increase in the manufacturing industry in Indonesia in 2014 amounting to USD 202.82 billion to USD 236.69 billion in 2018. Despite experiencing quite a significant increase over these 4 years, however, several manufacturing companies in Indonesia still ignore environmental problems.

The banking sector's engagement with ESG issues has many benefits, such as encouraging sustainable products, increasing customer and employee awareness and sensitivity to the importance of adopting socially responsible activities and behavior and improving reputation, legitimacy and ESG ratings. Therefore, evaluations regarding ESG performance in this sector have increased in recent years (Bektur and Arzova, 2022).

Based on the problems above and differences in results from several previous studies, ESG disclosure is considered to still be a concern for companies in Indonesia because it is still in a progressive stage in its implementation. Based on this research gap, this research was carried out further using a different research period and selecting the manufacturing and banking company sectors to test how ESG disclosure affects the firm's performance on operational performance, financial performance and market performance by collecting data in the form of financial reports and sustainability reports. manufacturing and banking companies listed on the Indonesia Stock Exchange (IDX) in the 2019-2021 period.

Literature Review

Legitimacy Theory

The underlying legitimacy theory is the connection between the company and society in a social relationship where the company carries out operations using economic resources. This theory was first proposed by Downling and Pfeffer (1975).

This theory helps companies know the company's boundaries regarding social norms and values, especially those related to the environment. The company believes that by following societal norms, society will provide positive feedback to the company. The company also believes that decisions and actions taken must be by societal norms and perspectives.

Stakeholders Theory

Freeman (1984) first coined his theory "Strategic Management: A Stakeholder Approach" which explains that a company's dependence on its capabilities accompanied by alignment of stakeholder interests will lead the company to prosperity and success.

In this theory, the company's success in managing its relationships with stakeholders and engaging in optimal social activities will increase in achieving company goals and success (Orij, 2010). Stakeholders are expected to have a positive impact on company performance when they invest or provide capital to the company.

Signaling Theory

In 1973, Spence popularized a theory called signaling theory, which shows how in the labor market there is an information asymmetry between employers and prospective employees, with the result that prospective employees try to provide signals through educational credentials to narrow this information asymmetry.

Signal theory is used by management to provide company information to stakeholders to give investors confidence about the security of company shares and enable investors to take advantage of their decisions (Gufranita *et al.*, 2022). Decision making made by investors comes from information used from annual reports including complete and accurate financial and non-financial reports.

ESG Disclosure

A new measurement in the development of voluntary information disclosure by companies, which initially originated from CSR reporting in annual reports and later became integrated reporting, is called ESG disclosure. ESG disclosure becomes a tactical tool to gain legitimacy through elements of corporate social responsibility. This disclosure also provides companies with accountability to the public and stakeholders that are used by them to maintain and build a foundation for creating firm value in the future (Faisal *et al.*, 2018).

The study of ESG-related criteria in enhancing corporate sustainability performance has been highlighted as increasingly important in recent years (Bassen *et al.*, 2006). Corporate disclosure of ESG performance will help reduce risks related to the impact of new regulations or fiscal actions (Freeman and Reed, 1983; Berman *et al.*, 1999) and attract socially responsible investors (Kapstein, 2001).

ESG is an advanced effort regarding the extension of corporate social responsibility and responsibility regarding socially responsible investment. However, the impact of ESG disclosure on corporate financial performance remains controversial.

Operational Performance

Operational performance is a measurement of the company's performance on the suitability of the process, performance evaluation, and quality of the company's activities related to the movement/delivery of goods by maintaining the quality of goods and/or services to customers based on standards or indicators that are effective, efficient, and socially responsible. Companies that have good ESG performance have a tendency to disclose more information about the actions taken by the company.

Financial Performance

Financial performance is a formal effort made by the company to achieve success in efficient and effective business activities properly and correctly. It is not easy to determine a success because the company may have large profits but not liquid. Therefore, the financial performance of a company can be analyzed or evaluate in terms of the ability to generate profits, dividend growth, and return loan capital so that the company shows the best condition so that investors want to invest funds.

About the disclosure of information related to the implementation of ESG by a company, the company sends signals to stakeholders through ESG disclosure. To increase trust and better relationships with stakeholders, ESG

disclosure will reflect the level of information transparency carried out by the company to increase profits in the future.

Market Performance

Poor corporate environmental performance and falling stock prices in the market cause investors to hesitate. The effect of market performance on ESG disclosure suggests that investing in ESG can increase shareholder wealth and contribute to the success of the company.

To maintain the existence of a company in the stock market, it is necessary to think about sustainable development about the future and continuous innovation to increase the company's market value. Buallay (2020) examines this issue with the results of ESG performance that impacts market performance. Along with high market value, the company's performance continues to increase. Continuous innovation and development can increase market value and retain stakeholders. Better performance will be followed by companies that have high market value. As a result, market performance is affected by ESG performance.

Leverage

Leverage shows a company's ability to fulfill its financial obligations if the company experiences liquidity at a certain time.

Firm Size

Firm size shows how big a company is (Jaya, 2020). Firm size can be calculated by calculating the natural logarithm of its total assets.

Framework and Hypothesis Development

The relationship between operational performance and ESG Disclosure is explained by Buallay (2018) where operational performance is measured by ROA as explained in the sustainability report disclosure which is seen as part of a company's good intentions so that better reporting disclosure will provide high ESG values and increase company ROA.

With legitimacy, a company has the opportunity to improve its performance and of course increase its profitability. Apart from that, ESG disclosure will determine stakeholder considerations regarding the future sustainability of the company and the way society provides legitimacy to the company. Based on this explanation, in this research the following hypothesis can be as follows:

H_{1a}: ESG disclosure positively affects the manufacturing sector's operational performance.

H_{1b}: ESG disclosure positively affects the banking sector's operational performance.

The test results conducted by Sarwono (2022) on the impact of ESG implementation on the performance of banking companies in the Far East Asia region show that ESG implementation has a negative impact on company performance as measured by ROA and ROE. This is due to the fact that companies must fulfill their responsibilities towards environmental sustainability which can have a negative impact on financial performance in the short term so that company profits will decrease due to additional costs for sustainability programs.

Research conducted by Gholami, Sands, and Shams (2022) states that the company's financial performance increases

due to ESG performance because the positive impact of ESG performance on financial performance is considered to help companies communicate with investors regarding the company's ESG performance.

Through the implementation of ESG disclosure, companies can gain legitimacy from stakeholders and society. By providing legitimacy to stakeholders and society, the company will have a good reputation. ESG disclosure is expected to affect or impact the company's financial performance because it discloses information about the company's position and activities on environmental, social, and governance aspects. Based on this explanation, in this research the following hypothesis can be as follows:

H_{2a}: ESG disclosure positively affects the manufacturing sector's financial performance.

H_{2b}: ESG disclosure positively affects the banking sector's financial performance.

According to Shakil (2020) in Rizqi Amalia and Indra Wijaya Kusuma (2023), companies that effectively consider ESG factors can reduce information asymmetry and stock price volatility in the market. Investors will see the company's performance from the information the company provides to them. Shakil (2021) also explained that low ESG in companies is usually volatile in the market because it is not environmentally and socially responsible. This results in investors hesitating to invest due to poor environmental performance and a decrease in stock prices in the market.

In research conducted by Agus Triyani, Suhita Whini Setyahuni, and Fiki Durrotul Makwuna (2021) explains how signal theory is used as a theoretical basis to find out how actions taken by companies to inform investors about the company's prospects with the results of social information that can reduce company risk and governance and social information that only have a negative impact on systematic risk.

High disclosure of environmental, social, and governance information can provide information to stakeholders on whether the report provides a good or bad signal for the future of the company. Investor decisions will have an impact on the company's annual return stock price. Increased stakeholder confidence will make it easier for companies to get investment, thereby increasing profitability. Based on this explanation, in this research the following hypothesis can be as follows:

H_{3a}: ESG disclosure positively affects the manufacturing sector's market performance.

H_{3b}: ESG disclosure positively affects the banking sector's market performance.

Research Methods

Population and Samples

This study utilizes manufacturing and banking companies listed on the Indonesia Stock Exchange (IDX). The criteria for *purposive sampling* in this study are (a) Manufacturing and banking sector companies listed on the Indonesia Stock Exchange (IDX) for three consecutive years from 2019 to 2021. (b) Companies that publish *annual reports* using rupiah currency. (c) Companies that publish *ESG Score* in 2019-2021. (d) Companies that have all data and information related to research variables from 2019 to 2021.

Operational Variables and Measurement Variables

According to Sekaran (2003), operational variables mean finding and measuring these variables in the field shortly and clearly while avoiding various interpretations. In this study, operational performance, financial performance, and market performance are the dependent variables, and ESG disclosure is the independent variable. In addition, there are control variables used, namely leverage and firm size.

Research Results and Discussion

Description of Research Sample

In this study, the data used is secondary data available on the Indonesia Stock Exchange (IDX). Manufacturing and banking sector companies listed on the IDX in 2019-2021 are the population used in this study. The *purposive sampling* method on this data becomes data for research samples.

Descriptive Statistical Analysis

The ESG manufacturing sector has a maximum value of 62.35 and a minimum value of 19.00. Then, the mean value is 41.79 and the standard deviation is 10.7024 where the value of the standard deviation has a smaller value than the mean value which indicates that the data distribution is normal. Meanwhile, the ESG banking sector has a maximum value of 57.51 and a minimum value of 23.76. Then, the mean value of 41.03 with a standard deviation of 9.9650 shows something similar to the manufacturing sector for normal data distribution.

Second, operational performance is the dependent variable in this study measured using ROA with maximum, minimum, mean and standard deviation values for the manufacturing sector of 0.36, -0.25, 0.06, and 0.0837. While the maximum, minimum, mean, and standard deviation values for the banking sector are 0.04, -0.09, 0.01, and 0.0234. Based on the measurement of the analysis of the manufacturing and banking sectors for ROA values through the mean and standard deviation values, it illustrates that operational performance for the standard deviation value is smaller than the mean value.

Third, financial performance is the dependent variable in this study measured using ROE with maximum, minimum, mean and standard deviation values for the manufacturing sector of 1.45, -1.50, 0.11, and 0.3392. While the maximum, minimum, mean, and standard deviation values for the banking sector are 0.21, -0.18, 0.07, and 0.0768. Based on the measurement of the analysis of the manufacturing and banking sectors, the ROE value through the mean and standard deviation of the manufacturing sector illustrates that financial performance for the standard deviation value is smaller than the mean value.

Fourth, market performance is the dependent variable in this study measured using Tobin's Q with maximum, minimum, mean and standard deviation values for the manufacturing sector of 16.49, 0.53, 2.12, and 2.2418. While the maximum, minimum, mean, and standard deviation values for the banking sector are 22.28, 1.60, 3.17, and 4.5910. Based on the measurement of the manufacturing sector analysis for Tobin's Q value through the mean and standard deviation values, it illustrates that the market performance for the standard deviation value is smaller than the mean value, while in the banking sector the standard deviation value has a value greater than the mean value which illustrates that the data distribution is wide.

Fifth, the leverage value in this study is a control variable for the manufacturing sector with a maximum value of 10.75 and a minimum value of 0.16. Then, the mean value is 1.38 and the standard deviation is 1.7991 where this figure shows that the standard deviation value is smaller than the mean value which illustrates that the data distribution is normal. In the banking sector the maximum value is 17.07 and the minimum value is 0.49. Then, the mean value of 5.78 with a standard deviation of 3.2159 also illustrates that the standard deviation value is smaller than the mean value where for the depiction of normal data distribution.

Sixth, firm size is another control variable in this study using the calculation of the natural logarithm of total assets to describe the measurement of this variable. Firm size for the manufacturing sector has a maximum value of 33.54 with a minimum value of 27.38. Then, for a mean value of 30.72 with a standard deviation of 1.1451, it explains that the mean is greater than the standard deviation, indicating that the data distribution is normal. Meanwhile, the banking sector has a maximum value of 35.08 and a minimum value of 27.91. Then, the mean value of 32.85 with a standard deviation of 1.8480 explains something similar to the manufacturing sector that there is a normal distribution of data.

Convergent Validity Test

The convergent validity test is used to find the cross loading results in the test results and compare the value of each construct value used. If the standardized loading factor has a value > 0.7 , then convergent validity is considered fulfilled. The results of all variables meet the criteria of the convergent validity test where the ESG, ROA, ROE, TQ, L, and FS variables show a value of 1,000 or higher than other constructs.

Discriminant Validity Test

The discriminant validity test is used to determine and compare discriminant validity and *root of average extracted* (AVE). A good discriminant validity test has the criteria for an AVE value > 0.5 .

The results of all variables meeting the criteria of the discriminant validity test through the AVE square roots value where the ESG, ROA, ROE, TQ, L, and FS variables show a value of 1,000 or higher than other constructs.

Reliability Test

The reliability test is used to determine the true value of the reliability of a construct and Cronbach alpha testing is used to determine the lower limit of the reliability value. In *composite reliability* and Cronbach's alpha, which can be fulfilled if the data tested has a value ≥ 0.70 .

the composite reliability test each variable has good *internal consistency* or has good reliability because it meets the criteria > 0.70 .

R-squared and Q-Squared values

To find out how much variability in the dependent variable can be explained by the dependent variable, evaluate the structural model or inner model using the coefficient of determination (R²) value. According to Ghazali & Latan (2016) the coefficient of determination explains the strength of each model, a value of ≤ 0.70 indicates that the model is strong, then ≤ 0.45 indicates that the model is moderate, and ≤ 0.25 indicates that the model is weak. Then, measuring the

predictive-relevance value (Q2) which is an advanced stage of the coefficient of determination with the criteria $Q\text{-square} > 0$.

ROA and Tobin's Q variables have a low value because the value of the $R\text{-squared} \leq 0.25$, while the ROE variable is at a moderate value because the $R\text{-squared value}$ is ≤ 0.45 . And also $Q\text{-squared}$ for the three variables of 0.165, 0.306, and 0.219 shows that it has predictive relevance because $Q\text{-squared} > 0$.

ROA variable has a moderate value because $R\text{-squared} \leq 0.45$, while the ROE and Tobin's Q variables have a strong value because $R\text{-squared} \leq 0.70$. In addition, the value of $Q\text{-squared}$ for the three variables is 0.725, 0.556, and 0.703 which shows the results of predictive relevance.

Hypothesis Test Results

The PLS paradigm, with PLS Mode A as the selected algorithm of the outer model, is used in this study. Partial Least Square (PLS) Mode A will be better for research that examines how the inner model affects the outer model on the correlation between latent variables (Ghozali and Latan, 2016).

Through the hypothesis testing used, researchers use an accuracy level of 95 percent to determine the level of significance and the value of the path coefficient. This shows that the maximum accuracy limit (α) is 5 percent or 0.05. The results of the analysis regarding the direct effect are described in table 1

Table 1: Hypothesis Testing

Hypothesis	Independent Variable	Dependent Variable	B-value	p-value
H _{1a}	ESG Disclosure	Operational performance	0,249	0,004
H _{1b}	ESG Disclosure	Operational performance	-0,075	0,303
H _{2a}	ESG Disclosure	Financial performance	0,259	0,003
H _{2b}	ESG Disclosure	Financial performance	-0,011	0,471
H _{3a}	ESG Disclosure	Market performance	0,327	<0,001
H _{3b}	ESG Disclosure	Market performance	0,002	0,496

Source: WarpPLS 8.0 output, 2023

Based on the results of hypothesis testing in table 1, it describes the results of hypothesis testing from research. The first hypothesis of ESG disclosure describes having a positive and negative and significant effect on operational performance for the path coefficient value of 0.249 and -0.075 and 0.004 and 0.303 for the significance level. The results for H_{1a} are in line with the research presented by Amina Buallay (2018) on ESG Disclosure where operational performance is measured by ROA as described in sustainability report disclosure which is seen as part of a company's goodwill so that better reporting disclosure will provide high ESG value and increase the company's ROA. While the research results for H_{1b} are rejected which is not in accordance with the research conducted by Amina Buallay (2018). This result is in line with research conducted by Velte (2019), Triyani et al., (2020), and Nugroho and Hersugondo (2022) which state that companies cannot prioritize only shareholders or one party in their business. Instead, companies must cooperate or do

business with all stakeholders, such as employees, communities, environmental organizations, governments, and other government organizations.

This result makes legitimacy and stakeholder theory in the banking sector not in line because the company still does not get much attention and good relations with the surrounding community that supports the company's operations. Meanwhile, stakeholder theory explains that the relationship between stakeholders and companies still needs to be improved regarding the importance of ESG in sustainability reports in the sustainability of the company's business operations to be able to make better investment choices and increase company value.

The second hypothesis also describes ESG disclosure as having a positive and negative and significant influence on financial performance for path coefficient values of 0.259 and -0.011 and 0.003 and 0.471 for the significance level. The results for H_{2a} are in line with research conducted by Lee and Isa (2022) that the application of ESG to financial performance has a positive or beneficial effect. Because the company can fulfill the interests of stakeholders who support the implementation of sustainable business, the company's financial performance will increase even though ESG practices will cause costs for these practices. While the research results for H_{2b} are in line with the test results conducted by Sarwono (2022) on the impact of ESG implementation on the performance of banking companies in the Far East Asia region showing that ESG implementation has a negative impact on company performance as measured by ROA and ROE. This is because companies must fulfill their responsibilities towards environmental sustainability which can negatively impact financial performance in the short term.

The third hypothesis describes the effect of ESG disclosure as having a positive and significant effect on market performance for path coefficient values of 0.327 and 0.002 and <0.001 and 0.496 for the significance level. These results are in line with research conducted by Shakil (2020) in Rizqi Amalia and Indra Wijaya Kusuma (2023), companies that effectively consider the existence of ESG factors that can reduce information asymmetry and stock price volatility in the market. Investors will see the company's performance from the information the company provides to them. Companies issue sustainability reports that attract investors to invest. Investors begin to invest in shares of companies that care about ESG (Trisnowati et al., 2022). With transparency about ESG, investors are starting to be interested in the fact that information that includes more than just financial statements is not enough for investors.

Conclusion

This study uses a sample of the manufacturing and banking sectors listed on the Indonesia Stock Exchange (IDX) in 2019-2021 which have consistency in disclosing comprehensive ESG scores on the Bloomberg Terminal. The sample used in the study used the manufacturing and banking sectors listed in 2019-2021 on the Indonesia Stock Exchange (IDX) which had consistency in disclosing comprehensive ESG scores on the Bloomberg Terminal. There are 150 research samples listed in the manufacturing and banking sectors in 2019-2021.

Based on testing conducted through various procedures ranging from data collection, data processing, data testing,

and interpretation of results, the research findings produce the following conclusions

- ESG Disclosure has a positive and significant effect on operational performance in the manufacturing sector, but has a negative and significant effect on the banking sector.
- ESG Disclosure has a positive and significant effect on financial performance in the manufacturing sector, but has a negative and significant effect on the banking sector.
- ESG Disclosure has a positive and significant influence on market performance in the manufacturing and banking sectors.

Limitations

Based on the tests that have been carried out, the limitations in this study are

- The coverage of data regarding ESG disclosures available on Bloomberg Terminal for manufacturing and banking sector companies listed on the Indonesia Stock Exchange in the 2019-2021 period is very limited. This is because only about 35 out of 431 or 8.12% of manufacturing companies have ESG Score data and meet the sample criteria and 15 out of 48 or 31.25% of banking companies have ESG Score data and meet the sample criteria.
- In this study, there are research findings that show in the measurement of the coefficient of determination Adjust R² on the dependent variable operational performance (ROA), financial performance (ROE), and market performance (Tobin's Q) in the manufacturing sector with a value of 0.099 or 9.9%, 0.250 or 25%, and 0.186 or 18.6% respectively, indicating that this value causes the influence of this research model which is still not quite ideal or the correlation between the independent variable and the dependent variable is very weak because the value of R² < 0.25. While in the banking sector, only the ROA variable has a value of 0.218 or 21.8% for a variable correlation that is very weak or not ideal enough.

Suggestions

Based on the conclusions and limitations of this study, several suggestions can be taken for further consideration, namely

- Future research can examine using other variables or factors that affect or are affected by ESG disclosure, such as board characteristics, audit committee characteristics, and earnings management, or consider other factors.
- Future research can examine using the same or different variables, sectors, and periods to get more varied and diverse research results.

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