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The Effect of Environmental, Social and Governance (ESG) Assessment on Firm Value with Profitability as a Mediating Variable

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Abstract

The development of recent issues regarding the climate change crisis, the impact of environmental damage, social welfare and good governance has forced several companies to adopt new assessment metrics Therefore, this study aims to analyze and examine the effect of ESG valuation on firm value, which is mediated by profitability. This quantitative research used secondary data, and the test used path analysis. The study's results prove that profitability (ROA) can mediate the relationship between ESG assessment and firm value (Tobin's Q). This study concludes that investors still see the value of profitability in considering the company's value in the future due to making investment decisions. This leads to capitalism, which means that investors still have difficulty exploiting the ESG aspect, so they must be assisted by looking at financial performance improvement in selecting companies for making investment decisions in the capital market.

Keywords

Environmental, Social and Governance (ESG), Firm Value, Profitability.

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Introduction

Current economic developments face challenges that need attention, namely competition between companies to maximize investor prosperity by increasing firm value. Firm value manifests the results of activities in the capital market carried out by investors. Firm value can be used as a reference for investment decisions. Firm value is an important element for investors because an increase in firm value will make investors interested in investing, followed by an increase in stock prices (Handini, 2022). In general, shareholders only focus on increasing the company's value and obtaining profits. However, investors should not ignore other goals of the company, namely to increase social welfare and preserve the environment.

The development of recent issues regarding the climate change crisis, the impact of environmental damage, social welfare and good governance has forced several companies to adopt new assessment metrics as additional information in reporting the impact of their business activities. Many of the factors contained in Environmental, Social, and Governance (ESG) have been accommodated in the implementation of

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Corporate Social Responsibility (CSR) which can be used as a reference for companies to show that companies have concern for current issues by considering the principles of sustainable development. Applying ESG to a company can help manage risks better from a business, community and environmental perspective.

The challenges in managing environmental risks, meeting social needs and good governance are opportunities for companies to make improvements or changes, hoping they will also affect company performance (Velte, 2017; Husada & Handayani, 2021). One of the most familiar financial ratios investors use is the profitability ratio. With this ratio, investors will have information about a company's performance and its potential to benefit them, increasing firm value (Anggraini & Agustiningsih, 2022). The function of the profitability ratio is as a comparison to determine the level of profit generated with the assets owned. The higher the profitability, the more efficient the company's management is in generating profits or profits based on the assets owned (Dewi & Suprapto, 2022). The principle of capitalism is still the basis for making investment decisions. Considering that the implementation of ESG creates a cost burden for companies, the implementation still needs improvement. Because the expenditures do not have a direct impact on the company, it is not impossible for the company to maintain its financial performance more than implementing its CSR. This study study aims to analyze and examine the effect of ESG valuation on firm value, which is mediated by profitability.

Literature Review

Stakeholder Theory

Stakeholder theory is one of the most widely used grand theories as a basis for research on sustainability reports. This theory explains that all stakeholders have the right to obtain information about company activities that can influence their decision-making (Deegan, 2004). Companies need to maintain the relationship between stakeholders and each other's interests by issuing sustainability reports that investors can assess directly, which will later influence their investment decisions in contributing to the company (Hörisch et al., 2020).

Firm Value

Firm value reflects investors' assessment of the company's performance in the capital market, which is represented by the stock price formed from the relationship between supply and demand in the capital market. Firm value can be used as a benchmark to see the company's development to increase shareholder confidence to attract investors to invest (Ponziani & Azizah, 2017). Firm value is the selling value of a company willing to be paid by investors as a business that goes hand in hand with the company's development (Azhar et al., 2018).

Profitability

Profitability is an important reference for measuring a company's ability to generate profits from its normal business activities (Hery, 2016). The profitability ratio measures the effectiveness of a company's management in carrying out its operations. Profitability ratios have goals and benefits for business owners, management and parties outside the company, especially those who have a relationship with the company (Kasmir, 2016).

Environmental, Social and Governance

Environmental, Social, and Governance (ESG) is a company guide in running a business or business based on several main criteria. These criteria describe the company's relationship with the surrounding environment, citizens, and transparent management (EBA Report, 2021). ESG is a company standard in investment practices to implement accountable company policies (Noviarianti, 2020). The ESG assessment reflects a transparent assessment based on the company's ESG performance and capacity, which is then integrated and considered for its materiality (Refinitiv, 2022).

Hypothesis Development

The use of the ESG metric is an innovation that has yet to receive much attention from investors because its relation does not directly impact the company's financial performance. Most companies with very good performance have taken a sustainability strategy and are more focused on long-term goals. It is hoped that applying ESG in business activities will provide more attractiveness to investors to invest. Research by Fatemi et al. (2018) show that ESG quality will increase firm value. However, research conducted by Handini (2022) shows that the environmental and governance components do not affect firm value, while the social component positively influences firm value. In line with Handini (2022), the results of research conducted by Velte (2017) and Safriani & Utomo (2020) also show that ESG disclosure has no significant effect on firm value. Based on this description, the hypothesis can be formulated as follows:
H1: ESG assessment has positive effect on firm value

The ESG assessment is expected by the company to help manage risk better from a business, community and environmental perspective because it is directly related to the company's operational processes. The ESG assessment in this study uses a risk value, so if there is a high-risk value it will give the view that the company may not have fully adopted it or not charged sufficient funds to address the issues raised in the ESG component. In accordance with capitalist principles, an increase in firm value can only be possible if there is an increase in the company's financial performance which will ultimately increase the welfare of investors. In addition, the disclosure of non-financial information is expected to be used as an important standard and strategy or indicator in assessing and evaluating how well the company is performing.

Several studies state that the research conducted by Fatemi et al. (2018) and Putri (2022) shows that ESG performance and quality will increase firm value. In contrast, Velte's research (2017) and Safriani & Utomo's research (2020) found that ESG disclosure does not affect firm value. Thus, there are inconsistencies in the results of the research that has been carried out, resulting hypothesis that the role of implementing ESG performance is still not strong enough to impact firm value directly, and investors still find it difficult to exploit its role. It is possible that the perception of investors in considering the company's value in the future is still dominated by the assessment of the company's financial performance. The research results of Dewi & Praptoyo (2022) and Jaya (2020) found that profitability (ROA) has an influence on firm value, which indicates that the level of profitability is still an important catalyst in considering investment decisions. Based on this description, the hypothesis can be formulated as follows:
H2: Profitability mediates the positive influence of the relationship between ESG assessment on firm value

Based on the problems and hypotheses proposed in this study, it can be clarified with theories and research concept models as shown in the image below.

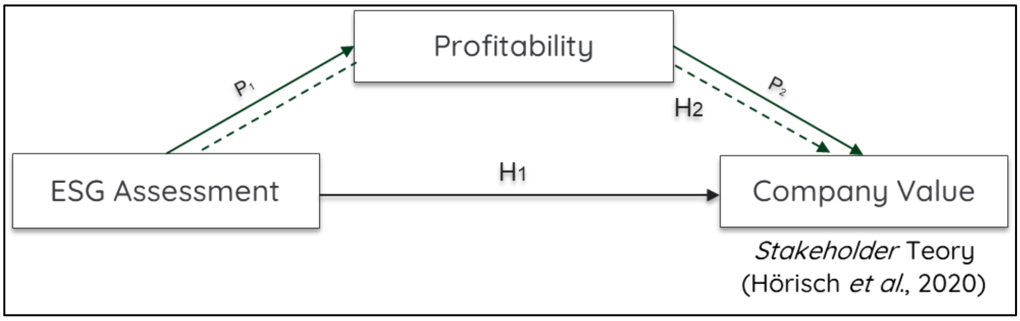

Figure 1. Conceptual Framework and Hypothesis Development

Research Method

This research uses a quantitative approach with secondary data. The data collection method is in the form of annual financial statements and sustainability reports that have been published by the company transparently through the official website of the Indonesia Stock Exchange (IDX) in 2021. This research uses path analysis because this research uses mediating variables. Analysis or interpretation of the research data results was carried out using the IBM Statistical Product and Service Solution (SPSS) Statistics 20.

Result and Discussion

Table 1 will show the results of the first model path analysis calculation between the ESG assessment of profitability (ROA). While Table 2 will show the results of calculating the second model path analysis between ESG assessment and profitability (ROA) on firm value (Tobin's Q).

Table 1. Path Analysis Test Results on Profitability (ROA)

Dependent Variable	Independent Variable	Standardized Beta Coefficient	t Count	Sig.	Description
ROA (Z)	E	-0.004	-0.024	0.981	Declined
	S	0.327	2.190	0.038	Approved
	G	-0.822	-4.544	0.000	Approved
	ESG	0.638	4.303	0.000	Approved

Source: Data analyzed, 2023

Table 2. Path Analysis Test Results on Firm Value (Tobin's Q)

Dependent Variable	Independent Variable	Standardized Beta Coefficient	t Count	Sig.	Description
Tobin's Q (Y)	E	-0.244	-1.235	0.229	Declined
	S	-0.206	-1.058	0.301	Declined
	G	0.118	0.403	0.691	Declined
	ESG	0.171	0.831	0.414	Declined
	ROA	0.467	2.274	0.031	Approved

Source: Data analyzed, 2023

According to Table 1, the first model path analysis calculation results are interpreted with the equation: **ROA = 0,638 ESG + e_1**. Based on Table 2, the results of the second model path analysis calculation are interpreted with the equation: Tobin's **Tobin's Q = 0,171 ESG + 0,467 ROA + e_2**. In the relationship between ESG assessment and firm value (Tobin's Q), there is an assumption of profitability (ROA) as a mediating variable. The results of calculating the effect of ROA as a mediating variable are interpreted with the equation: ***Indirect Effect* (IE) = 0,638 x 0,467 = 0,298**.

The recapitulation results of calculating the influence of the role of profitability (ROA) as a mediating variable relationship between ESG assessment of firm value (Tobin's Q) in this study are shown in Table 3, as follows.

Table 3. The Recapitulation Results of Calculating the Influence of Variable Mediator

Variable Relationships	Direct Coefficients		Standard error		Indirect Coefficients	(Se) Sobel	t Count	Sig.
	X→Z	Z→Y	X→Z	Z→Y				
X → Z → Y	0.638	0.467	0.016	0.133	0.298	0.0851	3.500	0.001

Source: Data analyzed, 2023

The test results state that profitability (ROA) can mediate a significant relationship between ESG assessment and firm value (Tobin's Q). Based on Table 3, the t_{count} value is 3.500 while the t_{table} is 2.055 ($t_{count} > t_{table}$). This value is greater than 2.055, meaning that the indirect effect model hypothesis of the ESG assessment variable on Tobin's Q through ROA is acceptable. It can be concluded that the mediating variable has a significant influence.

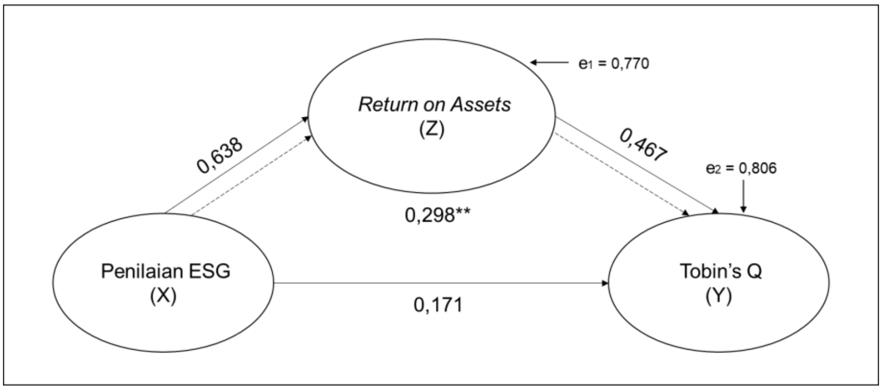

Figure 2. Diagram of the ESG, ROA, and Tobin's Q Assessment Variable Path Model

All the calculations carried out in this study resulted in a path analysis between variables. A diagram of the calculation results from the overall path analysis in this study has been shown in Figure 2.

ESG Assessment Does Not Influence Firm Value

The results showed that hypothesis 1 declined, meaning that the ESG assessment had no significant effect on Tobin's Q. The study results were proven by a t_{count} of 0.831 and a significance value of 0.414 (sig>0.05). This implies that disclosure of ESG performance is still not strong enough to impact firm value directly, and there is a lack of investor understanding of the importance of ESG assessments disclosed by companies, so investors still have difficulties exploiting their role.

The results of this study do not successfully support the statement of stakeholder theory that focuses on the success of an organization depends on the company's ability to achieve economic and non-economic goals, in this case investors have not considered ESG performance on information about the company's activities in making investment decisions. It can be said that the support provided by investors to a company can affect the existence of a company. This shows that the main goal of a company is to increase the prosperity of its stakeholders, but other goals such as non-economic will make the company less effective so that it gets less response from investors.

This study's results align with previous studies that prove ESG performance does not affect firm value (Velte, 2017; Safriani & Utomo, 2020). In addition, Handini's (2022) research also provided findings indicating that the environmental and governance components do not affect firm value, while the social component positively influences firm value. These results indicate that investors consider ESG assessments to be detrimental to their interests resulting in a decline in share prices on the market.

Profitability Mediates the Positive Effect of ESG Assessment Relationship on Firm Value

The study results show that hypothesis 2 is accepted, meaning that the role of ROA profitability (ROA) can significantly mediate the relationship between ESG assessment and firm value (Tobin's Q). The results of this study are proved by a t_{count} of 3.500 while a t_{table} of 2.055 ($t_{count}>t_{table}$) and a significance value of 0.001 (sig<0.05). It can be concluded that a higher ROA will be a good mediation for the relationship between ESG assessment and Tobin's Q. These results suggest that the role of ESG implementation still needs to be supported by the company's financial performance. Improved financial performance, as measured through ROA, is still an important consideration for investors in making investment decisions. The positive relationship from ESG illustrates the increased risk experienced by a company because the company does not optimally resolve the issues contained in ESG metrics. The significant influence on financial performance provides an explanation that the implementation of handling the resolution of issues on ESG metrics is still considered a burden by the company, so the company chooses to reduce the portion of funding that does not have a strategic impact on the continuity of the company's business.

The results of this study successfully support the statement of stakeholder theory by Handoko (2021) that companies are not only responsible for maximizing profits for investors, but also responsible for providing benefits to the community, social environment and government. Companies need to publish sustainability reports that can be assessed directly by investors which will later influence their investment decisions in contributing to the company (Hörisch et al., 2020). It can be said that stakeholders are interested in sustainability strategies by providing good ESG reporting that will affect the improvement of company performance, so as to increase the confidence of investors who also pay attention to the good non-economic state of the company. Thus, investors must consider ESG aspects in choosing companies for their investment decisions in the capital market.

Increasing corporate value results from ethical behavior and corporate responsibility, which aims to improve the welfare of society (Putri, 2022). In order to carry out their social and environmental responsibilities, companies need to pay attention to non-financial performance as contained in ESG aspects. The more investors understand the importance of sustainable aspects in business; the more incentives companies will have to pay attention to environmental and social issues. Research conducted by Velte (2017) proved that ESG performance has no effect on firm value, but ESG performance positively influences ROA. Higher profitability will increase the company's value, thus showing that the level of profitability is still an important catalyst in considering investment decisions (Dewi and Praptoyo, 2022; Jaya, 2020). This indicates that the company's value to investors will increase if there is an increase in the value of ROA. This all boils down to capitalism that ESG must increase the ROA value first, then it will affect Tobin's Q. So as long as the ROA value rises, Tobin's Q will also increase, no matter what causes the ROA value to increase. This is proven by the fact that there is no direct effect on the ESG assessment on firm value.

Conclusion

The results of this study prove that the role of profitability can significantly mediate the relationship between the ESG assessment and firm value. The higher the profitability, the better the mediation for the relationship between the ESG assessment and firm value. It can be said that stakeholders are still interested in the level of profitability owned by each company. Thus, investors still have difficulties in exploiting ESG aspects, so they need help by looking at financial performance improvements in choosing companies to make investment decisions on the company's capital market.

Notes on Contributors

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