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Does ESG Initiatives Affect Market Value and Profitability for Public Listed Companies in Indonesia?

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ABSTRACT
This study examines 246 listed companies in the Indonesian Stock Exchange (IDX) having reported their economic, social, and governance (ESG) disclosure in 2021with the aim to evaluate whether its ESG initiatives impacted the companies' market value and profitability. Sustainability investing, specifically based on ESG reporting of public listed companies has reached USD 71.1 billion globally between April and June of 2020. This shows ESG reporting has become an important factor for investors throughout the world. The Indonesian Financial Services Authority (OJK) introduced a circular in 2021 obliging public listed companies to include ESG reporting for their routine reporting to the public and financial authorities. This reporting requirement has increased the number of listed companies in IDX disclosing their ESG activities in 2021. Recent studies of ESG reporting in other markets shows that there is a positive relationship between ESG activities of publicly listed companies and their market value as well as their profitability. Using regression analysis, this study examines the economic, social, and governance disclosed initiatives of the 246 samples of the listed companies and the measure of market value using Tobin's Q and the measure of profitability using ROA. The findings shows that there are negative relationships between ESG disclosure and market value as well as profitability for listed companies in the IDX. This finding can be beneficial for stakeholders to improve their sustainability strategies and planning to increase the companies' attractiveness to green investors.

Keywords: *ESG, market value, profitability, Indonesia.*

1. INTRODUCTION

Ever since The United Nations launched the Principles for Responsible Investment in 2006, markets and financial information providers has continuously improved its offerings in providing information on sustainability of public companies. Out of those set of accepted principles, The Global Reporting Initiative (GRI) was launched as a non-profit body with a mission to assist governments and companies in reporting their sustainability impacts. The GRI framework further impacted the business world with a standard for assessing sustainability risks in the form a reporting framework for Environment, Social, and Governance (ESG) programs that are initiated by businesses.

ESG reporting has since saw increase in importance both by market data providers and investors. Study shows that investments in companies implementing ESG principles has reached USD 71.1 billion globally between April and June of 2020 even during the Covid-19 pandemic [1]. This shows that many investors and fund managers have adopted ESG as a factor in their decision making. For businesses, ESG reporting is used as a communication media to show their commitments to sustainable practices such as risk management and sustainable practices towards the companies' stakeholders for increasing stakeholder value [2].

In the case of public listed companies in Indonesia, the Indonesian Financial Services Authority (OJK) in 2021 introduced a circular redefining a framework for reporting by public listed companies which include environmental, social, and governance (ESG) reporting. That circular is followed by the introduction of sustainable reporting standards by the Indonesian Stock Exchange (IDX); which made ESG reporting a requirement. That new requirement has significantly increased the number of companies disclosing ESG reports from 54 in 2020, to 135 in 2021 [3].

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Although ESG reporting is a recent practice/requirement for companies listed in IDX, the authors are interested whether ESG activities influence the market value and profitability of the companies listed in Indonesia. The market value and financial performance of a company is of interest in this study since those indicators reflect the attractiveness of the company in the stock market. Thus, this study intends to examine the relationship between ESG practices and corporate financial performance of companies in the IDX. suitable.

2. LITERATURE REVIEW

This study is based on the perspective of stakeholder theory, which suggests that firms should anticipate the demands of both internal and external stakeholders. ESG activities are viewed as efforts by management to address these stakeholder demands and improve firm performance.

ESG reporting as a form transparency initiative should be seen as strategic moves by organizations. Firstly, disclosing nonfinancial information helps corporations gain positive legitimacy from important stakeholders, therefore enhancing their reputation. Secondly, it allows corporations to showcase their commitment to ethical values, boosting their reputational capital [4].

ESG initiatives therefore should impact aspects of a firm's financial performance. This study uses both accounting-based and market-based measures as indicators of financial performance. The firm's performance is evaluated using the firm value, and profitability.

2.1. Environmental, social, governance

ESG is commonly used in a company's Corporate Social Responsibility (CSR) efforts. Recently, ESG information has gained significant attention due to its impact on stakeholders' long-term investments (not just shareholders). ESG goes by various names such as Corporate Social Disclosure (CSD) and Corporate Social Responsibility Disclosure (CSRD). It involves measuring, disclosing, and being accountable to both internal and external stakeholders. A company's ESG score reflects its performance in working towards sustainable development goals. ESG reports encompass areas like resource usage, human rights, corruption levels, community relations, etc. Shareholders view ESG reports as indicators of a firm's strength, risk management, and overall effectiveness [5].

A quick search on Google Scholar shows that there have been many studies conducted related to ESG practices and reporting in Indonesia (9420 results). A search on Scopus however only shows 4 results. This shows that there is gap for studies conducted related to ESG practices in Indonesia in top tier journals.

2.2. ESG reporting and the firm's performance

Reporting ESG activities by publicly listed firms has gained popularity, if not required, since it potentially provides competitive advantage and improve stakeholder relations. Public disclosure of ESG activities also create the expectation of increasing firm value and/or profitability since it allows the firm to align different stakeholders' interest, credibility, and competitiveness [6] [7].

Recent studies shows that ESG practices/performance have a positive effect on the value of the businesses [8],[7] as well as stakeholders value [2]. Furthermore, increased company value will in turn positively effect investment returns for the shareholders. Over 90% of ESG studies conducted since the year 2000 shows that ESG has a positive effect on financial performance variables and corporate financial performance [9].

Of the various studies examining ESG in relations with the firm's performance, measuring the firm's Tobin's Q and ROA are accepted measures for a firm financial performance.

2.3 Tobin's Q

Tobin's Q is a financial ratio that are considered a good measure of a company's long term financial performance [10]. Equation (1) is formal definition in calculating the Tobin's Q.

$$\text{Tobin's Q} = \frac{Market\ value\ of\ firm}{Replacement\ Cost\ of\ Firm'sAssets} \quad (1)$$

Since the ratio divides the market value with the company's assets replacement cost (which is considered the company's intrinsic value), it is an indicator whether the company is overvalued or undervalued. Therefore, a company that gain a higher Q ratio implies superior performance. Calculating the Q ratio is not easy. This is due to the difficulty of acquiring the value for "replacement cost of firm's assets" [11]. An approximation for calculating the Q ratio was developed by Chung and Pruitt (1994) using total assets as the denominator [12],[11]. Equation (2) is defined the as the approximation for measuring Tobin's .

$$\text{Aprox. Q} = \frac{Mrkt.\ Value\ of\ Equity + Preferred\ Stocks + Debt}{Total\ Assets} \quad (2)$$

Market Value of Equity = (share price) x (number of shares outstanding)
Preferred Stocks = liquidation value of fiem's outstanding preferred stock
Total Assets = book value of total assets

2.4. Return on Asset

ROA is also a financial ratio which is calculated by dividing a company's net income with its total assets. ROA as an accounting based metric has been used extensively in many studies is an indicator for the profitability of a company [13]. ROA is defined in equation (3).

$$\text{ROA} = \frac{Net\ income\ after\ taxes}{Average\ total\ assets} \quad (3)$$

This study uses a company's earnings after taxes in calculating ROA.

Thus, the following hypothesis can be developed:

Hypothesis 1: ESG has a positive impact on market value.

Although some studies shows that ESG have a negative effect on a firm financial performance, most studies show otherwise [13].

Hypothesis 2: ESG has a positive impact on profitability.

3. METHODOLOGY

3.1. Sources of data

This study uses secondary data is sourced from a data provider (ESGI) which focuses in collecting ESG and financial data which are sourced from yearly annual and sustainability reports publicly disclosed by companies listed in the IDX. The sample consist of 246 firms across all sectors that produced their ESG and financial reports in 2021.

For this study, the dependent variables are the firm's financial performance, which consists of Tobin's Q (the market value of a company divided by its' assets replacement cost) and the return on asset of the company (ROA). Furthermore, the independent variables used consists of: 1. ESG general score, 2. ESG economic score, 3. ESG social score, 4. ESG governance score.

3.2 Study model

In measuring the impact of ESG activities of a firm, this study apply the regression model (4).

$$\text{Perf}_{firm} = \beta_0 + \beta_1 EV + \beta_2 SC + \beta_3 GO + \varepsilon \quad (4)$$

Where:

EV = environment score

SC = social score

GO = governance score

4. RESULT AND DISCUSSION

Results show that for both ROA and the Q regression, there are almost no correlation with the environment, social, and governance scores of the firm. Furthermore, the p-values of variables for the two regression models are significantly above 5%. Therefore, it can be concluded that the environment, social, and government scores which are derived from the firms' reports are not significant to those firms' financial performance; namely the firms; ROA and Tobin's Q.

Regression results also show that the value of R-Squared from Tobin's Q is a little bit higher than ROA but still it has a low value (not more than 5%). The small value from R-Squared means the regression model does not fit the data or it can be said that there is no significant contribution from independent variables to dependent variables.

From coefficient values, each independent variable makes a little impact, while the intercept value (especially Tobin's Q model) has a larger impact. It can be seen also that the results from ROA and Tobin's Q are not consistent, which means it might be insignificant effect from independent to the dependent variable.

From p-value score, it can be concluded that all variables have scores > 5% which means that the null hypothesis has a big probability to be true and it also means that there is no effect in the observation.

Table 1. Regression results

	ROA	Tobin's Q
Multiple R	0.05397225	0.10348885
Adjusted R Square	0.00944757	-0.0015539
Standard Error	0.11584809	1.48229169
Coefficients		
Intercept	0.02677059	1.98337385
Environment Score	-0.0044201	0.00437841
Social Score	0.004686	-0.4992981
Governance Score	0.02381811	-0.2974865
p-value		
Intercept	0.19212711	7.6512E-13
Environment Score	0.87333066	0.99015203
Social Score	0.89256326	0.26132207
Governance Score	0.41478538	0.42598849

In examining the results, it is conclusive that ESG activities and the firms' performance bears no significant relationships. This is contradictory to other studies done in more advanced economies. As an example, a similar study done by Amina Buallay [14], shows that ROA and Tobin's Q have a strong relationship with ESG reporting in the European banking sector. On the other hand, A study done by Atan et al. [15] shows that ESG scores of sampled companies in Malaysia are statistically insignificant to those companies' Tobin's Q. A study done by Baldini et al. [16] in the service sector of companies listed in the Bombay Stock Exchange shoes that there is a significant negative relationship between ROA and the environmental score [17].

5. DISCUSSION

This study aims to examine the relationship between reported ESG activities of listed companies in the Indonesian stock exchange and the companies' financial performance, namely with its financial performance and ROA. Results show that there is no significant relationship. The regression models shows that ESG scores as independent variables has no significant contribution to the Q ration and ROA as dependent variables. The interesting results is contradictory to results of similar studies done in more advanced economies; at the same time, a study done in Malaysia revealed similar results [15]; that there are no significant relationships between reported ESG activities and financial performance measures such as Tobin's Q and ROA. Other studies in emerging markets such as India offered mixed results [16, 18]; in some cases there were positive relationships between the firm's performance and ESG activities, but in others, there were not.

An explanation for the results is that ESG reporting was only introduced in 2017 by the Indonesian government; furthermore, OJK made sustainable reporting a requirement only in 2021. Outside of foreign fund managers, it seems that local retail investors are less sensitive to the importance of sustainable practices and reporting. Thus, ESG reporting is not a factor for an investor's stock purchase decision. This fact seems unintuitive since it creates a contradiction with stakeholder's theory. Companies' actions that consider the interests, needs, and concerns of various individuals and groups who are affected by the companies' actions did not positively affect the companies' financial performance. The results is also further impacted due to the global economic deterioration because of the COVID-19 pandemic.

Another plausible explanation for the results can be derived from another study in emerging markets. A study by Garcia et al [19] shows that one of the ESG components, namely the environmental reporting, has significant relationship with the firm's performance specifically in highly environmentally sensitive industry sectors. If the company operates in an environment that has a high risk of impact to its environment, sustainability reporting becomes an important factor.

This study faced many limitations and can be further enhanced by future studies. Due to the novelty of sustainable reporting in the IDX, there exists limited data (only 246 firms in 2021) of firms that complied with the ESG reporting requirement. This of course will improve in the future. A study done by Rezaee et al. [20] shows that mandatory ESG disclosures (such as in the IDX) will result in higher numbers of disclosures compared to stock markets having voluntary regimes. Furthermore, this study was conducted at a time of recovery from a pandemic and economic uncertainty due to geopolitical issues.

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