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The Effect of ESG Disclosure on Financial Performance with Earnings Management as an Intervening Variable

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ABSTRACT

This study was conducted to examine the impact of ESG disclosure on financial performance with earnings management as an intervening variable. The final sample studied using purposive sampling technique in this study amounted to 160 data in the observation year 2019–2022 with companies in the manufacturing, real estate and mining sectors as the research population. The quantitative method was chosen in this study with data obtained from the Indonesian Stock Exchange, the official website of the sample company, and the Thomson Reuters Eikon website. The research model uses panel data regression analysis with the best model chosen is the Random Effect Model (REM), while to test the mediating variables is to use the Sobel test using a Sobel test calculator. From the tests conducted, the results prove that ESG disclosure has a significant positive effect on financial performance and earnings management cannot mediate the relationship between ESG disclosure and financial performance.
Keywords: Financial Performance, ESG Disclosure, Earnings Management

INTRODUCTION

Financial performance is material for analyze the extent to which the company can achieve its achievement targets which depend on profits or increased revenue. Basically, companies with good results and increased from the previous year are able to continue business. However, currently companies are not only financially responsible, but are also required to be responsible for environmental damage (Sari *et al., 2023*).

The sustainability of the company's life can be examined through the relationships that exist between the company, both to the community and the environment around the company stands. Environmental, Social, and Governance (ESG) activities can be categorized as a company's commitment to improve social welfare and bring long-term sustainability to stakeholders, so these activities gain traction among investors as they seek to seize long-term investment opportunities and make a meaningful impact on society (Agarwal *et al* ., 2023; Özer *et al* ., 2023) .

The Paris Climate hosted by the United Nations Framework Convention on Climate Change (UNFCCC) Council in 2015 resulted in the "Paris Agreement", the goal of which is to limit global temperature rise to below 2°C or preferably below 1.5°C from pre-industrial levels. In the same year, the United Nations (UN) approved 17 Sustainable Development Goals or SDGs (Sustainable Development Goals) to guide UN member states in achieving sustainable development. Indonesia has also set a series of ambitious goals in line with the UN SDGs and the Paris Climate Agreement, namely by issuing the Financial Services Authority Regulation POJK Number 51/POJK.03/2017 which requires Financial Services Institutions – banks and non-banks – as well as issuers and public companies to submit sustainability reports.

This study adds an intervening variable to determine the relationship between ESG disclosure and financial performance. The intervening variable is earnings management. Earnings management is the practice of manipulating financial statement carried out by company management in order to gain profits. In addition, by implementing and disclosing ESG which requires more costs, earnings management was chosen as an intervening variable to determine whether companies apply earnings management practices to their financial reporting so that the financial statements presented are not in actual condition.

LITERATURE REVIEW

Stakeholder Theory

Stakeholders are defined as groups or individuals who are influenced or affect the process of achieving company goals (Freeman, 1984). The groups or individuals referred to in stakeholders consists of shareholders, employees, government, consumers, creditors, and society. The use of the stakeholder concept is a mechanism for gathering intelligence to more accurately predict environmental opportunities and threats (Freeman, 1984). Based on the perspective of stakeholder theory and the concept of sustainability, ESG activities can form a competitive advantage for companies and become a source of opportunities or companies innovation (Ruan & Liu, 2021) .

Agency Theory

Agency theory is a contractual relationship between management and shareholders (Jensen & Meckling, 1976). This agency relationship creates agency problems for management and shareholders because they will always try to maximize their benefits and the actions taken by each party may not be in line (Adryanti, 2019; Apriadi et al ., 2022). Shareholders want high returns on their investment, while managers want to get high restitution for their performance. In addition, there is information asymmetry between the two because managers understand the information and conditions of the company better than shareholders (Jensen & Meckling, 1976). One example of a manager's actions that conflict with shareholders is when managers carry out earnings management.

Financial performance

Financial performance is an understanding of a company's financial visibility to achieve its economic goals (Velte, 2019). Financial performance is an indicator of good or bad assessment of the company's finances so that it can predict the company's finances in the future. Financial performance assessment is also used in order to find out whether the company is able to use all assets to earn profits at a certain time effectively and efficiently (Fatihah & Widiatmoko, 2022). Therefore, information about financial performance is very useful for all parties, both internal and external parties to the company. Financial performance is measured by calculating the Return on Assets (ROA) ratio with the following formula:

$$ROA = \frac{Net\ Profit\ After\ Tax}{Total\ Assets}$$

Environmental, Social, and Governance (ESG)

Environmental, Social, and Governance (ESG) is non-financial information that refers to how a company can handle issues regarding non-financial information (Kovács & Bassen, 2008). ESG has three aspects related to sustainable development goals, namely environmental, social and governance aspects. These aspects aim to contain additional information in the financial statements that is not present in the accounting data (Kovács & Bassen, 2008). ESG measurements uses the ESG disclosure score, the Thomson Reuters Eikon. ESG scores range from 0 (D-) which is the worst to 100 (A+) which is the best.

Earnings management

Earnings management is a management activity that deliberately changes the financial reporting process in order to gain personal or company benefits (Apriadi *et al.,* 2022). The application of earnings management certainly does not represent the real situation of the company, resulting in bias in financial statement information because this has the potential to mislead decision makers (Adryanti, 2019; Apriadi *et al* ., 2022). But on the other hand, this earnings management activities does not violate the provisions in financial accounting standards because managers only use the options in these standards to align certain motives of managers (Apriadi *et al* ., 2022). Earnings management measurement is proxied by *discretionary accruals* (DAC) based on the Modified Jones model with the following formula:

1. **Calculate total accruals**

$$TAC_{it} = NI_{it} - CFO_{it}$$

Noted:

TACit : Total accruals of company i in year t
NIit : Net income of company i in year t
CFOit : Cash flow operations of company i in year t

2. **Calculating the value of total accruals**

The value of Total Accruals (TAC) is estimated using a regression equation with the following formula:

$$TAC_{it}/TA_{it-1} = \alpha_1 (1/TA_{it-1}) + \alpha_2 ((\Delta REV_{it} - \Delta REC_{it})/TA_{it-1}) + \alpha_3 (PPE_{it}/TA_{it-1}) + e$$

Noted:

TACit : Total accruals of company i in year t
TAit-1 : Total assets of company i year t-1
ΔREVit : Company i's income in year t minus income in year t-1
ΔRECit : Change in company i's receivables from year t-1 to year t
PPEi : Fixed assets of company i in year t-1
e : Error

3. **Calculating Non-Discretionary Accrual**

Regression performed on the total accrual value by equation number 2, will result in coefficients α1, α2, and α3. This coefficient are used to determine Non-Discretionary Accrual which is entered into the following equation:

$$NDA_{it} = \alpha_1 (1/TA_{it-1}) + \alpha_2 ((\Delta REV_{it} – \Delta REC_{it})/TA_{it-1}) + \alpha_3 (PPE_{it}/TA_{it-1})$$

Noted:

NDAit : Non-Discretionary Accrual of the company in year t

4. **Determining Discretionary Accrual**

Discretionary Accrual is calculated using Total Accrual (TAC) with Non-Discretionary Accrual (NDAC). The formula for calculating DA is as follows:

$$DAC_{it} = (TAC_{it}/TA_{it-1}) - NDAC_{it}$$

Noted:

DACit : Discretionary Accrual of company i in year t

The Effect of ESG Disclosure on Financial Performance

ESG disclosure is one way of maintain good relations with all stakeholders, because by providing ESG disclosure information, stakeholders can find out the transparency of sustainable issues that are very useful in making strategic decisions that affect company performance, then if the company operates well , will improve good relations and gain the trust of stakeholders so that it can increase company profits in the future (Sari *et al* ., 2023 ; Jessica & Triyani, 2022 ; and Rengganis, 2019). Previous studies conducted by Lee & Isa (2022), Hamdi *et al.,* (2022), Ihsani *et al.,* (2023), and Özer *et al.,* (2023) obtained positive results between ESG practices and company financial performance .

H1 : ESG disclosure has a positive effect on financial performance

The Effect of ESG Disclosure on Financial Performance with Earnings Management as an Intervening Variable

Good financial performance can influence the decisions of investors and other stakeholders. However, there are several companies using earnings management practices in presenting their financial performance to benefit the company. Earnings management practices can be influenced by ESG disclosure activities. There are two different views regarding ESG disclosure on earnings management practices. First, the ESG disclosure encourages managers to behave honestly and reliably because such behavior is beneficial to the company, so that the involvement of ESG in the company has a positive impact on earnings quality (Almubarak *et al* ., 2023) . Second, companies can use ESG as a tool to cover the negative impacts of distorted financial reporting practices and mislead potential investors' perceptions of actual company information, and managers who undertake ESG initiatives aim to cover up opportunistic earnings management activities and ensure that company information is transparent (Kolsi *et al* ., 2023 ; Almubarak *et al* ., 2023) .

H2 : Earnings management mediates the relationship between the effect of ESG disclosure on financial performance

RESEARCH METHOD

In this study, there are dependent variable, namely financial performance, independent variable, namely ESG disclosure, mediating variable, namely earnings management, and control variables, namely firm size and firm age. The research method taken is quantitative research with the objects of manufacturing, real estate, and mining sector companies listed on the BEI in the 2019–2022. The sample of this study was taken utilizing purposive sampling technique to obtain qualifications that are in accordance with this study. The data source taken is by channeling the official website of the Indonesian Stock Exchange or company's website to get the annual report and also accessing the official website of Thomson Reuters Eikon website to get the ESG score of the company under study. This study applies panel data analysis in testing the impact of independent variable on the dependent variable. The regression model is tested through model testing first to get the optimal regression model between the Common Effect Model, Fixed Effect Model, and Random Effect Model . The panel data regression model used in this research is as follows:

$$\mathbf{ROA_{it} = \mathit{a} + \beta_1ESG_{it} + \beta_2DAC_{it} + \beta_3SIZE_{it} + \beta_4AGE_{it} + \mathit{e}} \quad \textbf{(1)}$$

Noted:

ROAit : Return on Assets (Proxy of Financial Performance)
a : Constant
β1,2,3,4 : Regression Coefficients
ESGit : Environmental, Social, and Governance
DACit : Discretionary Accrual (A Proxy of Earnings Management)
SIZEit : Company Size
AGEit : Company Age
e : Error

This study also uses an online Sobel test calculator to determine the indirect effect of the independent variable on the dependent variable through the mediating variable. The regression model equation (2) used to test the intervening variable prerequisites is as follows:

$$\mathbf{DACit = a + \beta 1ESGit + \beta 2SIZEit + \beta 3AGEit + e} \quad \textbf{(2)}$$

Noted:

a : Constant
DACit : Discretionary Accrual (A Proxy of Earnings Management)
β1,2,3,4 : Regression Coefficients

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ESGit : Environmental, Social, and Governance

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RESULT AND DISCUSSION

The Effect of ESG Disclosure on Financial Performance

After conducting regression tests, the results obtained are Random Effect Model so that the results obtained are ESG as an independent variable has a significant positive impact on financial performance (ROA), as evidenced by the T_{value} of 4.66 > T_{table} 1.98 and a sig value of 0.000 < 0.05. The regression coefficient value is 0.2200328 and the sig value is 0.000 < 0.05. This proves that there is a significant positive influence between ESG disclosure on financial performance so that hypothesis 1 (H1) is accepted. The results of this study indicate that ESG disclosure improves company's financial performance. The results of this study are in line with research by Ihsani et al., (2023), Lee and Isa (2022), and Özer et al., (2023) which prove that ESG disclosure has a positive effect on financial performance. According to Ihsani et al., (2023) the better the company's ESG performance, the better its financial performance and with a good ESG commitment, the company will be more stable in its operational and financial activities. The results of this study support stakeholder theory, which explains that ESG practices reflect good corporate management because they fulfill the interests of all stakeholders, thus having a positive impact on performance (Freeman, 1994). The purpose of corporate involvement in environmental, social, and governance activities is to reduce corporate risks, improve market performance and increase the company's sustainable development capabilities (Ihsani et al., 2023).

Earnings Management Mediates the Effect of ESG Disclosure on Financial Performance

Based on the results of the online Sobel test calculator, it is known that the Sobel statistical number in the Sobel test is -0.39152978 < 1.98. Thus, it can be concluded that earnings management cannot mediate the effect of ESG disclosure on financial performance, so hypothesis 2 (H2) is rejected. The results of this study support agency theory which discusses the negative impact of earnings management on financial performance because there are differences in interests between managers and stakeholders resulting in financial information asymmetry (Chakroun & Amar, 2022) .

CONCLUSION

The results prove that ESG disclosure has a significant positive effect on financial performance. Thus, ESG disclosure can affect financial performance. These results prove that by disclosing ESG and with a good ESG commitment, the company will be more stable in its operational and financial activities. However, in this study earnings management cannot mediate the impact of ESG disclosure on financial performance, so that earnings management which acts as an intervening variable cannot be proven. These results have implications for related companies and investors, which can increase knowledge about the impact of ESG disclosure on financial performance; the impact of ESG disclosure on earnings management; and earnings management on financial performance, thus enabling companies to report sustainability reports, maintain their sustainability reporting, and build a positive corporate reputation, thus gaining the trust of shareholders, and helping investors make the right decision to invest.

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