



THE EFFECT OF ENVIRONMENTAL SOCIAL GOVERNANCE ON FINANCIAL PERFORMANCE
WITH THE COST OF CAPITAL AS AN INTERVENING VARIABLE

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ABSTRACT

This study aims to determine the effect of ESG on financial performance with the cost of capital as an intervening variable. The intervening variable in this study is the cost of capital as measured by the weighted average cost of capital (WACC) based on the company's annual report. The independent variable in this study is Environmental Social Government (ESG) as measured using Thomson Reuters Eikon. The dependent variable in this study is financial performance as measured by Return Of Asset (ROA). The population of this study in manufacturing and real estate sector companies listed on the Indonesia Stock Exchange (IDX) for the 2019-2022 period. The sampling technique used in this method is purposive sampling with a total sample of 156 data. The data analysis method in this study uses multiple regression analysis with STATA 17 and path analysis with the help of an online sobel calculator. The results of this study indicate that ESG disclosure has a positive effect on financial performance, environmental disclosure has no significant positive effect on financial performance, social disclosure has no significant positive effect on financial performance, and governance disclosure has no significant positive effect on financial performance. In addition, the cost of capital is unable to act as a mediator in the effect of ESG on financial performance.

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INTRODUCTION

A sustainable business can be achieved if it can achieve economic aspects related to profit, social aspects related to people, and environmental aspects related to the planet (Boiral et al., 2019) and is supported by the implementation of effective corporate governance (Jaimes-Valdez and Jacobo-Hernandez, 2016). Several cases in Indonesia show that business activities have not implemented social and environmental responsibility properly. The Ministry of Environment and Forestry reported the development of environmental damage cases until 2018, namely 462 companies involved in environmental damage cases (Head of Environmental Public Relations of the Ministry of Schools and

Forests, 2018). Some of these cases occurred in Freeport Indonesia and Lapindo Brantas (Agustina et al., 2015). PT Freeport Indonesia dumped commercial waste into the Papuan environment without permission from the local community and the government. The state lost USD 12.95 billion due to PT Freeport Indonesia's violations (News Desk, 2018). PT Lapindo Brantas caused damage to settlements and local residents in Sidoarjo, East Java due to oil drilling activities that caused hot mudflow (Fitrianto, 2012). The company's indifference to the impact of its business activities on environmental damage is caused by poor environmental, social and governance performance (Shakil, 2021). Effective implementation of environmental, social and governance principles can provide benefits for businesses to support their operations. The implementation of environmental and social governance can improve a business's ability to learn to identify risks and innovate in business, improve its reputation in capitalizing on business opportunities, and improve the quality of its management through transparency, maintaining the long-term sustainability of the company and supporting financial performance (Association of Chartered Certified Accountants, 2013).

LITELATURE REVIEW

Business activities are too focused on economic efficiency and profit generation, thus ignoring the impact of business on natural damage (Cai et al., 2015), social and economic, environment (Carroll & Shabana, 2010). Tao Fu, Jiangjun Li (2023) in their research stated that there is a significant influence between ESG on the company's financial performance. Muhammad Affan Rizqi and Munari (2023) in their research state that corporate social responsibility has a significant positive effect on the financial performance of Raisa Almeyda, and Asep Darmansyah (2019) state that there is a statistically significant positive relationship between ESG with ROA and ROC of the company.

Stakeholder Theory

Stakeholders are defined as groups or individuals who are affected by or influence the efforts to achieve corporate goals (Freeman, 1984). Groups or individuals known as stakeholders include shareholders, employees, government, consumers, creditors, and society. The utilization of the stakeholder concept serves as a way to gather intelligence information that enables more precise predictions of environmental opportunities and threats (Freeman, 1984). Based on the viewpoint of stakeholder theory and the concept of sustainability, ESG activities can be a source of competitive advantage for companies as well as an opportunity for innovation (Ruan & Liu, 2021).

Agency Theory

Agency theory is a contractual relationship between management and shareholders (Jensen & Meckling, 1976). This relationship creates agency problems between management and shareholders, as both seek to maximize their respective profits, which can result in incompatible actions (Adryanti, 2019; Apriadi et al., 2022). Shareholders want a large return on their investment, while managers want to get high rewards for their performance. In addition, there is information inequality between the two, because managers have a deeper understanding of company information and conditions than shareholders (Jensen &

Meckling, 1976). One example of a manager's action that conflicts with the interests of shareholders is when the manager performs earnings management.

Environmental Social Governance

The independent variable of this study is ESG which is something that must be fulfilled to support economic, social and environmental performance to achieve corporate sustainability goals.

ESG = Database Asset4 Thomson Reuters

Financial Performance

The dependent variable in this study is financial performance expressed in return on assets (ROA). ROA is a ratio used to measure the ability of a company's assets to generate net income.

$$ROA = \frac{\text{net profit after tax}}{\text{total assets}}$$

Cost Of Capital

The intervening variable raised in this study is the cost of capital proxied by the Weighted Average Cost of Capital (WACC). cost of capital proxied by Weighted Average Cost of Capital.

$$WACC = (E/V * Re) + [(D/V * Rd) * (1-T)]$$

E = Total Equity

D = Total Debt

V = E+D

Re = Cost Of Equity

= Risk Free + Beta Shares * (Market Return - Risk Free)

Rd = Cost Of Debt

= Interest Expense / Interest Payable * (1- Tax Rate)

Tc = Corporate Tax Rate

E/V = Percentage of Equity Capital

D/V = Percentage of Capital in the Form of Debt

Company Size

The size of the company is an indicator of the financial strength of a company (Fadilah et al.2022).The size of the company is regulated in the Law of the Republic of Indonesia No.20 of 2008 which explains how much the size of the company can be exceeded based on the total assets and sales of the company. The size of a company can be determined from various aspects. In determining the size of the company, this study refers to previous studies, namely research by Zahid et al. (2022).

$$\text{Size} = \ln (\text{Total Aset})$$

Company Age

The age of a company is the length or life cycle of the company and can be used as a factor to limit managerial discretion. The age of a company shows that the company is growing, competitive, and able to take advantage of business opportunities in the economy (Jessica and Triyani, 2022).

Age = Tahun Observasi – Tahun Berdiri

The Effect of ESG Disclosure on Financial Performance

ESG disclosure is one of the methods to maintain good relationships with all stakeholders, because by providing information regarding ESG disclosure, stakeholders can understand the transparency of sustainability issues that are crucial in making strategic decisions that impact the company's performance. Furthermore, if the company operates effectively, this will strengthen good relations and gain trust from stakeholders, which can increase the company's profits in the future (Sari et al., 2023; Jessica & Triyani, 2022; and Rengganis, 2019). Previous research conducted by Lee & Isa (2022), Hamdi et al. (2022), Ihsani et al. (2023), and Özer et al. (2023) showed positive results regarding the relationship between ESG practices and corporate financial performance.

H1: ESG disclosure has a positive effect on financial performance

The Effect of ESG Disclosure on Financial Performance with Cost of Capital as an Intervening Variable

ESG disclosure is one method to maintain positive relationships with all stakeholders. With information on ESG disclosures, stakeholders can understand the transparency of sustainability issues that are crucial in helping them make strategic decisions that impact the company's performance. If the company operates effectively, it will strengthen good relations and gain trust from stakeholders, which in turn can increase the company's profits in the future (Sari and Widiatmoko, 2023; Triyani et al. 2020; Rengganis, 2019). ESG also supports companies in determining better strategies (Agarwal et al. 2023).

H2: Cost of capital mediates the relationship between the effect of ESG disclosure on financial performance

RESEARCH METHOD

This study has financial performance as the dependent variable, ESG disclosure as the independent variable, cost of capital as the mediating variable, and company size and company age as the control variables. The research methodology used is a quantitative survey of manufacturing, real estate and mining sector companies listed on the IDX for the 2019-2022 period. The research sample was taken using purposive sampling technique to obtain appropriate qualifications for this study. The data source is the Indonesia Stock Exchange or the company's official website to get the annual report, and the official Thomson Reuters Eikon website to get the ESG score of the surveyed companies you can also. This study uses panel data analysis to test the effect of independent variables on the dependent variable. Regression model testing is done by first testing the model to get the best regression model between the common effect model, fixed effect model, and random effect model. The panel data regression model used in this study is:

$$\text{ROA}_{it} = a + \beta_1 \text{ESG}_{it} + \beta_2 \text{WACC}_{it} + \beta_3 \text{SIZE}_{it} + \beta_4 \text{AGE}_{it} + e \quad (1)$$

Noted :

- ROA_{it} : Return on Assets (Proxy of Financial Performance)
- a : Constant
- β_{1,2,3,4} : Regression Coefficients
- ESG_{it} : Environmental, Social, and Governance
- WACC_{it} : Weighted Average Cost of Capital (A Proxy of Cost of Capital)
- SIZE_{it} : Company Size
- AGE_{it} : Company Agee: 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 as follows:

$$\text{WACC}_{it} = a + \beta_1 \text{ESG}_{it} + \beta_2 \text{SIZE}_{it} + \beta_3 \text{AGE}_{it} + e \quad (2)$$

Noted :

- a : Constant
- WACC_{it} : Weighted Average Cost of Capital (A Proxy of Cost of Capital)
- β_{1,2,3,4} : Regression Coefficients
- ESG_{it} : Environmental, Social, and Governance
- SIZE_{it} : Company Size
- AGE_{it} : Company Agee: Error

RESULT AND DISCUSSION

The Effect of ESG Disclosure on Financial Performance

After conducting the regression test, the results obtained are Random Effect Model so that the results obtained are ESG as an independent variable has a significant positive effect on financial performance (ROA), as evidenced by the Thitung value of 4.63 > Ttabel 1.98 and a sig value of 0.000 < 0.05. The regression coefficient value is 0.1455462 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 the company's financial performance. The results of this study are in line with the research of 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, so that they have a positive impact on performance (Freeman, 1994). The purpose of corporate involvement in environmental, social, and governance activities is to reduce corporate risk,



improve market performance, and increase the company's sustainable development capabilities (Ihsani et al., 2023).

Cost of Capital 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 on the Sobel test is $0.00241006 < 1.98$. Thus, it can be concluded that the cost of capital 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 capital costs on financial performance due to conflicts between the company and its stakeholders and reduces the company's cost of capital. (Donaldson & Preston, 1995).

CONCLUSION

This study shows that the disclosure of ESG issues has a significant positive effect on financial performance. Therefore, ESG disclosure can have an impact on financial performance. The results show that through ESG disclosure and appropriate ESG initiatives, the company's operational and financial activities become more stable. However, this study cannot prove the cost of capital as an intervening variable because it cannot mediate the effect of ESG disclosure on financial performance. This finding has implications for affiliates and investors. It means that we can increase our knowledge about the impact of ESG disclosure on financial performance. The impact of ESG disclosure on the cost of capital. This allows companies to publish sustainability reports, maintain sustainability reports, and build a positive corporate reputation, thereby gaining shareholder trust and helping investors make informed investment decisions.

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