

Performance Effect of Environmental, Social and Governance (ESG) Disclosure: Case of Indonesian Companies

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Performance Effect of Environmental, Social and Governance (ESG) Disclosure: Case of Indonesian Companies

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Abstract

The objective of this study is to investigate the effect of Environmental, Social and Governance (ESG) disclosure to financial and market performance of Indonesian companies listed in LQ-45 stock index. This research adopted GRI.G4 indices to measure ESG disclosure. Two types of performance consists of ROA as the indicator of financial performance and abnormal return as the proxy of market performance. The finding of this research reveals that three aspect of ESG disclosure have different effect on market performance. Market performance has positive response toward social disclosure but negative toward higher environmental disclosure. In addition, Companies with high governance disclosure do not have significant influence on market performance. The financial performance effect of ESG disclosure resulted in the positive effect of governance disclosure to ROA. The finding indicates that the implementation of environmental, social and governance policy as the path toward corporate sustainability still provide least impact toward short-term firm performance.

Keywords: Environmental, Social, Governance, Disclosure, ROA, Abnormal return

1. INTRODUCTION

Environmental, social and governance (ESG) issue in recent decade arise to promote the sustainable business, where company develops a balanced and integrated approach to meeting its economic, environmental, and social responsibilities to its stakeholders (Pojasek, 2007). This paradigm is stemming from the popular triple bottom line approach (Žak,2015), and adding with governance aspect to support value creation for stakeholders. The joint report of the United Nations Environment Programme Finance Initiative (UNEPFI) and World Business Council for Sustainable Development WBCSD (2010) stated that incorporating environmental, social, and governance (ESG) elements as well as sustainability is more relevant in making corporate decisions.

This research is focusing on Indonesian companies listed in LQ-45 index, known as stock market index with higher market capitalization and liquidity. It is believed that companies with higher market capitalization tend to disclose more information which allows them to engage more with corporate governance, social and environmental responsibility (Aerts, Cormier, Gordon, and Magnan, 2006).

2. LITERATURE REVIEW

The main theory that used in this study is signaling theory. According to the theory, the internal party try to convey signal to the outside parties in reducing the problem of information asymmetry between management of company and external parties (Conelly, 2011). In this context, ESG disclosure is viewed as positive signal on company's quality to pursue balancing goals toward sustainability. Furthermore, company with great extent of ESG disclosure is perceived to have great prospect in the future (Lys et. al, 2015). The positive feedback from investor will be revealed by positive market performance. Previous

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research found that companies with higher ESG disclosure were followed by higher financial and market performance (Larcker, Richardson, & Tuna, 2007).

A good corporate governance system provides effective protection for shareholders and creditors. Corporate governance also creates a conducive environment for sustainable and efficient growth in the corporate sector. As a return, company with good corporate governance practice will be under the radar investor to make investment. Thus, the trading transaction caused a positive abnormal return. Hence, the higher ESG disclosure will impact higher abnormal return. Therefore, it can be hypothesized that:

H1: Environmental disclosure has a positive effect on market performance

H2: Social disclosure has a positive effect on market performance

H3: Governance disclosure has a positive effect on market performance

Previous research on ESG found that ESG contribute to the corporate performance. Fried *et. al* (2015) revealed that roughly 90% of studied find positive link between environmental, social and governance on corporate financial performance. Research From Deutsche Asset Management (2015) found out only 10% of the study about CSP and CFP showed negative finding. The aspect of environment responsibility, for instance, will enhance company to create environmentally friendly business. This policy in turn, contributing to the competitive advantage for company, where there is positive feedback from stakeholder due to company's environmental responsibility and environmentally friendly business. The best practice of corporate social responsibility can reduce the risk of discrimination, resolve complaints internally, and ensure a respectful and supportive atmosphere for all employees (Flammer, 2013). Being socially responsible may increase the loyalty of customer, because the company more transparent about its product. This transparency will increase the trust of customer and directly increase customer loyalty (Kajüter, 2014). Next component of ESG deal with governance. Good corporate governance practice will also gain trust from stakeholder and then increase the financial performance. In sum, company policy on environmental, social and governance will only increase the financial performance when there is a good communication with internal stakeholder and external stakeholder through a good corporate disclosure. Therefore, higher disclosure about ESG will contribute to the higher profitability that hypothesized as follows:

H4: Environmental disclosure has a positive effect on financial performance

H5: Social disclosure has a positive effect on financial performance

H6: Governance disclosure has a positive effect on financial performance

3. METHODS

This study has two dependent variables. The first dependent variable is financial performance and the second is market performance. While the independent variable in this study are environmental disclosure, social disclosure and governance disclosure.

Financial Performance

Financial performance measured by Return on asset. According to Yang, Lin & Chang (2010) ROA_{t+1} is used to measure the effect of disclosure. return on asset are measured for t+1 period as follows :

$$ROA_{t+1} = \frac{\text{Earning after tax}_{t+1}}{\text{Total asset}_{t+1}}$$

Abnormal Return

Abnormal return is the difference of expected return and return realization. Return Realization was calculated as follow :

$$R_{i,t} = \frac{IHSI_{i,t} - IHSI_{i,t-1}}{IHSI_{i,t-1}}$$

Where: $R_{i,t}$ = Return Realization stock i on period t; $IHSI_{i,t}$ = Historical stock price on period t; $IHSI_{i,t-1}$ = Historical stock price on period t-1. Expected return was measured by CAPM approach :

$$E(R_{i,t}) = Rf_t + \beta_{i,t}(Rm_t - Rf_t)$$

Where $E(R_{i,t})$ = Expected Return of stock i on period t; Rf_t = Risk free rate of return, represented by SBI; Rm_t = Market return over the period t; and $\beta_{i,t}$ = Measure of each stock return versus market return

ESG Disclosure

ESG disclosure was measured using GRI G4 Index individually rather than composite, because they have disparate elements (Friede et.al, 2015). Measurement of the disclosure in this study uses content analysis of social, environmental and governance disclosure based with score's dichotomy approach (Pusparida, 2016 and Atan et.al, 2016).

$$\text{environmental indicator disclosure} = \frac{\text{environmental indicator disclosed}}{34}$$

$$\text{social indicator disclosure} = \frac{\text{social indicator disclosed}}{48}$$

$$\text{Governance disclosure} = \frac{\text{social indicator disclosed}}{22}$$

Sample and method of analysis

This study population is all companies that listed in LQ-45 Indices. The sample in this study were taken by purposive sampling method. The criteria set out that company is incorporated in LQ-45 indices for each year for the second period of index announcement. Other criteria related to data availability on annual report or sustainability report during the period.

This study has two method analysis. Regression model is used to know about the influence of ESG disclosure to market performance and financial performance. Since this study has 2 dependent variables, there are 4 regression equation model. The first was intended to determine whether ESG disclosure affected the Abnormal Return (Abn_Return) of LQ-45 index (equation 1), The second is to investigate whether ESG disclosure as Independent variable affected the profitability of company which measure by ROA_{t+1} . The regression equation in this study are as follows:

$$Abn_Return - LQ45 = a + b_1ENV_1 + c_2SOC_2 + d_2GOV_2 + e_2SIZE_2 + e \dots\dots\dots(1)$$

$$ROA_{t+1} - LQ - 45 = a + b_1ENV_{1t} + c_2SOC_{2t} + d_2GOV_{2t} + e_2SIZE_{2t} + e \dots\dots\dots(2)$$

4. FINDING AND DISCUSSIONS

Descriptive Statistic

Table 1
Descriptive Statistic of Regression model

Variable	N	Minimum	Maximum	Mean	Std. Deviation
Abnormal returns	209	-0.8147	0.8120	-0.0462	0.3066
ROA _{t+1}	209	0.0009	0.4157	0.0859	0.0833
ENV	209	0.0000	0.9706	0.2921	0.2517
SOC	209	0.0208	0.9167	0.3418	0.2149
GOV	209	0.0909	1.0000	0.5467	0.1660
SIZE	209	28.4260	34.445	31.0691	1.3275

From the table 1 above it can be seen that final sample is 209. Mean value of abnormal return is -0.0462 and standard deviation of abnormal return 0.3066 respectively. ROA_{t+1} shows minimum value of 0.0009 and maximum value for 0.4157. Environmental disclosure has mean value of 0.2921, lower than mean value of social disclosure (0.3418) and governance score (0.5467).

Results of hypothesis testing

This research used multiple regression analysis to test the hypotheses. Since the hypotheses test using regression analysis, then some classical assumptions must be met such as normality test, autocorrelation test, heteroscedasticity test, and multicollinearity test. Based on the results, all the classic assumption test had been met. The result of hypotheses test can be seen in table 2.

Table 2 Hypotheses Test Result of Regression Model

	Model	B	T	Sig
Model 1	Constant	-0.783	-1.637	0.103
	ENV	-0.597	-4.343	0.000**
	SOC	0.469	2.812	0.005**
	GOV	0.200	1.451	0.148
	SIZE	0.021	1.325	0.187
Model 2	Constant	2.860	1.781	0.076
	ENV	0.138	0.298	0.766
	SOC	0.488	0.873	0.384
	GOV	1.003	2.166	0.032**
	SIZE	-0.210	-4.011	0.000**

Note: * significant at 10%, ** significant at 5%, *** significant at 1%

The result of regression model shows that environmental and social disclosure variable have significant effect to market performance. However, environmental disclosure has a negative sign, meaning that there is negative effect of environmental disclosure on market performance. This finding is consistent with Wu, Linxiao & Sulkowski (2010). Their research revealed that environmental disclosure has significantly negative influence to market performance measured by Tobin's Q. Investment in environmental aspect can be considered as high cost for company. Therefore, the influence of environmental will not be felt in short-term period. The result of social disclosure in line with the signalling theory and support the hypothesis. This result also consistent with the research of Syafrullah (2016) who found that social disclosures in Indonesia and Malaysia companies has positive influence on abnormal return. Higher social responsibility can give a direct positive feedback to company through the increasing motivation of labour, responsible to society, increase product responsibility and reduce gender discrimination. Governance disclosure variable has no significant effect on abnormal return.

Environmental and social disclosure has no significant effect on ROA. This result in line with research from by Nor et al. (2016) which found out that there is no significant influence between environmental disclosure on financial performance which is ROA, ROE and EPS in Malaysia. To perform good environmental and social responsibility company must perform many activities that trigger a higher cost and takes time to give the effect. Governance disclosure of LQ-45 has positive influence on ROA. corporate governance practice not environmental or social practice. Focus on good corporate governance may oversee the optimal operational performance of company.

5. CONCLUSION

This study found that social disclosure has significantly positive influence to market performance. Environmental disclosure in this study pointed out a opposite direction with the hypothesis. Governance disclosure did not has significant effect to market performance. This is because the practice of governance disclosure in Indonesia is still low. Social disclosure of LQ-45 showed a non significant effect to ROA, this is because the focus of LQ-45 index not for social responsibility. Governance disclosure only has significant effect on ROA for LQ-45 Index. There is a focused tendency of LQ-45 to governance disclosure.

This research has some limitations. The first is this study must conduct subjective calculation in assesing ESG score using content analysis. Second, limited scope of sample using only companies listed in LQ-45. The result might cannot be generalized into broader context. Regarding with the limitations of this research, there are some suggestions for the future research. First, next research can use ESG disclosure score from rating provider. Second, further research may extent the sample for broader index such as IHSG.

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