DIJEFA:
Dinasti International Journal of Economics, Finance & Accounting
E-ISSN: 2721-303X
P-ISSN: 2721-3021
https://dinastipub.org/DIJEFA dinasti.info@gmail.com +62 811 7404 455

DOI: https://doi.org/10.38035/dijefa.v6i2

The Effect of Environmental, Social, and Governance on Financial Performance of Manufacturing Companies Listed on the Indonesia Stock Exchange (IDX)

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Abstract: This study investigates the simultaneous impact of Environmental, Social, and Governance (ESG) variables on the financial performance of manufacturing companies listed on the Indonesia Stock Exchange (IDX) from 2018 to 2023. A 2020 survey by Globescan and the Global Reporting Initiative (GRI) revealed a significant rise in public trust regarding sustainability report disclosures, with Indonesia ranking first among 27 countries at 81%. Despite this, Indonesia's ESG implementation shows weaknesses in social and environmental responsibility, as reflected in the 2021 Environmental Performance Index (EPI), where Indonesia ranked 22nd out of 25 Asia-Pacific countries in environmental sustainability. This quantitative study utilized documentation techniques and secondary data from the IDX, focusing on 79 companies, with 11 ma.nufacturing firms as the sample. The findings indicate that ESG factors positively affect financial performance, with a significant (Sig) value of 0.000. However, the environmental aspect alone does not significantly impact financial performance (Sig 0.151). In contrast, both social and governance factors show a strong positive effect on financial performance, each with a Sig value of 0.000. These results highlight the importance of social and governance practices in enhancing corporate financial outcomes.

Keyword: Environmental, Social, Governance, Financial Performance.

INTRODUCTION

Financial performance is an evaluative measure that can be assessed through ratio analysis to determine the financial health of a company within a specific period (Faisal, Samben, & Pattisahusiwa, 2018). According to Hutabarat & Puspita (2021), financial performance analysis is conducted by evaluating financial ratio reports against agreed-upon standards and predicting the company's future prospects. One method to reflect a company's financial performance in each period is through its financial ratios, which provide essential information regarding the company's financial status. Financial ratio data offers numerous benefits and purposes. Septiana (2019) asserts that financial ratio reports deliver crucial information to relevant stakeholders. A company's financial performance encompasses liquidity, solvency, and profitability capabilities (Darmawan, 2020). Zahroh & Hersugondo (2021) found that despite continuous improvements in Environmental, Social, and Governance (ESG) performance, this does not necessarily correspond to enhanced financial performance as measured by Return on Assets (ROA). The average ROA percentage fluctuates inconsistently, sometimes increasing and decreasing irregularly, indicating that the relationship between ESG and financial performance is not always direct or linear. Unilever Indonesia Tbk. has shown a declining trend in ROA over five years, dropping from 46.66 in 2018 to 29.29 in 2023. Conversely, PT Industri Jamu Dan Farmasi Sido Muncul Tbk demonstrated better financial performance during the same period, with its ROA increasing from 19.89 in 2018 to 27.07 in 2023.

In modern business practices, companies are not solely driven by profit. They increasingly recognize the importance of integrating sustainability into their operations, considering not only financial gains but also environmental impacts, social implications, and governance practices in their daily activities. Balancing these four key aspects enables businesses to achieve long-term success and generate a positive impact on their surrounding environment (Boiral et al., 2020). Exceptional corporate performance in ESG reflects a company's commitment to enhancing societal and environmental welfare while upholding ethical business practices through rigorous oversight (Kim et al., 2021). Effective ESG implementation can yield profits, improve risk understanding, foster business innovation, enhance reputation, ensure long-term sustainability, and support financial performance.

A 2020 survey conducted by Globescan and the Global Reporting Initiative (GRI) revealed a significant increase in public trust towards sustainability reports, with an average trust level of 51%. Indonesia recorded the highest trust level at 81% among the 27 surveyed countries, ranking first. However, ESG implementation in Indonesia still lacks adequate social and environmental responsibility. The 2021 Environmental Performance Index (EPI) ranked Indonesia 22nd out of 25 Asia-Pacific countries in environmental sustainability. Thus, Indonesian companies require robust management systems with standardized ESG operational guidelines.

Concrete cases from Indonesian companies illustrate ESG challenges. In the Environmental aspect, PT Semen Indonesia Tbk faced public protests in 2018 in Rembang, Central Java, over environmental pollution and damage to local water sources caused by its mining operations (Tempo, 2018). In the Social aspect, PT Pan Brothers Tbk, a textile and garment company, faced criticism in 2021 for mass layoffs without proper severance pay, violating Indonesian labor laws (Kontan, 2020). In terms of Governance, PT Krakatau Steel Tbk, a state-owned steel company, was involved in a corruption scandal in 2019, raising concerns about corporate transparency and governance practices (Kompas, 2024). Weak ESG practices often lead companies to neglect the environmental and social impacts of their business activities (Shakil, 2021). Kristiani & Werastuti (2020) define environmental performance as a company's ability to manage environmental care efforts and reduce the negative impacts of its operations (Majidah & Aryanti, 2022). A company's environmental performance directly influences its level of social responsibility (Fahreza & Inawati, 2023). Safriani & Utomo (2020a) describe social performance as a company's demonstration of its commitment to social responsibility, playing a crucial role in fostering positive relationships and achieving success both personally and professionally (Yoo & Managi, 2022). Syafrullah & Muharam (2017) state that governance involves regulations determining interactions among stakeholders, managers, companies, creditors, governments, and employees. Governance evaluation typically relies on disclosure scores considering stakeholder rights, organizational structure, director authority, and management practices (Melinda & Wardhani, 2020).

Research by Wahdan Arum Inawati & Rahmawati (2023) investigated the impact of ESG on financial performance, aiming to determine the influence of environmental, social, and governance factors on the financial performance of non-financial sector companies. Aboladaka et al. (2023a) found that ESG in Indonesia does not fully support financial performance positively, whereas in Malaysia, ESG significantly enhances financial performance. According to Khairunnisa & Widiastuty (2023), corporate governance dedication leads to transparent financial reporting and performance. ESG performance negatively impacts company performance as proxied by ROA, while Husada & Handayani (2021a) state that ESG implementation affects financial performance from the perspective of company assets. Khairunnisa & Widiastuty (2023) also revealed differences between domestic and international companies.

These discrepancies in previous studies form the basis for this research, which aims to explore the impact of ESG on the financial performance of manufacturing companies listed on the Indonesia Stock Exchange (IDX) from 2018 to 2023. While prior studies predominantly assessed financial performance using Return on Assets (ROA) and Return on Equity (ROE), this research employs Tobin's Q to produce more significant results and differentiate from earlier studies. The novelty of this research lies in the selection of the most recent study period compared to previous research. To date, no studies have utilized data from these recent years, providing a more accurate and relevant representation of current conditions. The primary objective of this research is to examine the influence of Environmental, Social, and Governance (ESG) factors on the financial performance of manufacturing companies listed on the IDX between 2018 and 2023. This study holds significant value as it offers insights for companies seeking to adopt sustainable practices and enhance corporate social responsibility efforts. Additionally, investors can utilize these findings to assess investment risks based on companies' ESG reputations and performance.

METHOD

This study employs a quantitative research method utilizing documentation techniques to collect data sourced from secondary data, such as annual reports and sustainability reports of manufacturing companies listed on the Indonesia Stock Exchange (IDX) at https://www.idx.co.id/id. The independent variable, Environmental, is measured using the ratio derived from (Total Environmental Disclosure Items by the Company) / (Total Disclosure Items). The Social variable is measured using the ratio of (Total Social Disclosure Items by the Company) / (Total Disclosure Items), while the Governance variable is assessed using the ratio of (Total Governance Disclosure Items by the Company) / (Total Disclosure Items). The dependent variable, financial performance, is measured using the Tobin's Q ratio formula, with the following standard: if $Q < 1$, the ratio is considered "under," indicating that the company's market value is lower than the replacement cost of its assets, suggesting the company may be undervalued or its assets are not optimally utilized compared to the market. Conversely, if $Q > 1$, the ratio is considered "over." The ratio values are compared with the average financial performance from 2018 to 2023. If the ratio is under, it is considered to have no effect, while if the ratio is over, it is considered to have an effect.

The population of this study includes manufacturing companies listed on the Indonesia Stock Exchange (IDX) during the period from 2018 to 2023, totaling 79 companies. The sample selection criteria include: first, manufacturing companies that consistently published annual reports and sustainability reports from 2018 to 2023 and are easily accessible; second, the selection of accurate and comprehensive data to support the research results. Out of the total 79 companies, 11 companies met the specified criteria, resulting in a dataset comprising 66 data points.

The data analysis technique used in this study is Panel Data Analysis, which consists of time series and cross-sectional data. The integration of time series and cross-sectional data can be conducted within a single regression model framework using panel data. The use of panel data is relevant when the same phenomenon occurs repeatedly in the same items across space and time, allowing for comprehensive conclusions regarding the phenomenon. This study employs a normality test, with the requirement that the Jarque-Bera value > 0.05; an autocorrelation test, with the requirement that the Durbin-Watson value falls between dU and 4-dU; a multicollinearity test, with the requirement that the VIF value < 10 or the tolerance value > 0.1; and finally, a heteroscedasticity test, with the requirement that the p-value of the Glejser test > 0.05 (Imelda et al., 2021). Hypothesis testing is conducted using Eviews12 software. The research model in this study aims to prove the relationship between ESG and financial performance

$$Q = \frac{MVE+Liabilities}{Total\ Assets}$$

Market Value of Equity (MVE) : The market value of a company's equity.
Liabilities : The total debt of the company.
Total Assets : The total assets of the company.

RESULTS AND DISCUSSION

In the descriptive statistical test, it can be interpreted that the number of observations is 66 data points. The descriptive test includes the minimum and maximum values, the mean, and the standard deviation (Std. Deviation). The following are the results of the descriptive test:

Table 1 descriptive statistical test

	Kinerja	*Environmental*	*Social*	*Governance*
Mean	1.877727	0.369992	0.079494	0.565660
Median	0.905000	0.354839	0.038468	0.483334
Maximum	7.550000	0.903230	0.307700	1.000000
Minimum	-0.040000	0.064516	0.000551	0.166700
Std. Dev.	1.974541	0.244706	0.092143	0.273182
Observations	66	66	66	66

Based on the results of the descriptive statistical test presented in Table 1, the analyzed data includes 66 observations for each of the studied variables, namely Financial Performance, Environmental, Social, and Governance. The analysis provides a clear overview of the value distribution for each variable. For the Financial Performance variable, the mean value is 1.877727 with a standard deviation of 1.974541. This indicates that the average Financial Performance is relatively high; however, the variation around the mean is also considerable. The standard deviation being greater than the mean suggests significant differences between individual values and the average, indicating substantial variability in the Financial Performance data.

For the Social variable, the mean value is 0.079494 with a standard deviation of 0.092143. Here, the standard deviation is also larger than the mean, indicating that although the average Social score is relatively low, there is considerable variation among individual values. This reflects a high degree of variability within the Social data. Conversely, for the Environmental variable, the mean value is recorded at 0.369992 with a standard deviation of 0.244706. In this case, the standard deviation is smaller than the mean, suggesting that although there are some differences, individual values are relatively closer to the average. This indicates higher consistency in the Environmental data compared to the Financial Performance and Social variables.

The Governance variable has a mean value of 0.565660 and a standard deviation of 0.273182. Here, the standard deviation is also smaller than the mean, implying that despite some variations in the data, the individual values for Governance tend to be more uniform relative to the average. Overall, the results of the descriptive analysis indicate that the data for Financial Performance and Social variables exhibit considerable variability, while the Environmental and Governance variables demonstrate relatively greater consistency. This variation in the data provides essential information about the distribution of values and the extent of differences between individual values and the mean in this study.

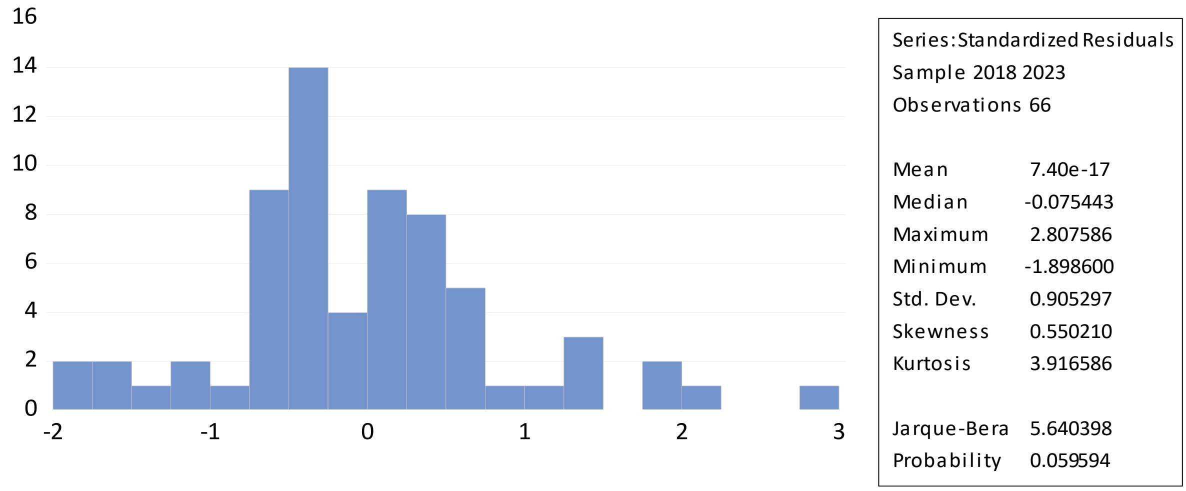

Figure 2. Normality Test Results

Normality and Autocorrelation Test Results

The results of the normality test indicate a significance value (p-value) of 0.059, which exceeds the 0.05 significance level. This implies that the null hypothesis, which states that the data are normally distributed, cannot be rejected. Therefore, the data in this study can be considered to follow a normal distribution at the 5% significance level, allowing the application of parametric statistical methods that require the normality assumption.

In the autocorrelation test, the obtained Durbin-Watson (dW) value is 2.188. In the context of α = 5%, with 4 independent variables (k) and 66 observations (N), this Durbin-Watson value is compared with the lower bound (dU) and the upper bound (4 - dU) to identify the presence of autocorrelation. In this study, the dW value falls between dU 1.697 and 4 - dU 2.303, specifically 1.697 < dW 2.188 < 2.303. Thus, the dW value lies within the range that does not indicate the presence of autocorrelation, in accordance with the established criteria.

Multicollinearity, Heteroscedasticity, and Panel Data Test Results

Table 2. Multicollinearity Test

	Environmental	*Social*	*Governance*
X1	1.000000	0.404564	0.780488
X2	0.404564	1.000000	0.450708
X3	0.780488	0.450708	1.000000

The multicollinearity test is conducted to determine the presence or absence of correlations among independent variables in the regression model. Ideally, independent variables should not be correlated with each other, as such correlations indicate a lack of orthogonality. This test is performed by calculating the correlation coefficients of each independent variable, where a value below 0.8 indicates the absence of multicollinearity. Based on the available data, it can be concluded that there is no multicollinearity within the dataset.
Furthermore, the heteroscedasticity test results show that variable X1 has a coefficient of -0.381759 with a p-value of 0.3309, indicating that this variable is not statistically significant at the 5% significance level. Variable X2 has a coefficient of 1.689122 with a p-value of 0.0753, approaching the significance threshold, while variable X3 has a coefficient of 1.522646 with a p-value of 0.1001, also not significant at the 5% level. The heteroscedasticity test results indicate that the probability values for each variable are above 0.05, suggesting no evidence of heteroscedasticity in the data.

The panel data test in this study employs the fixed effects model after conducting model selection tests. The regression model used in this study is as follows:

$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$

The panel data linear regression was subsequently conducted, yielding the following results:

Y = -0.8590 - 1.3595*X1 + 11.4701*X2 + 4.1155*X3

Regression Model Interpretation

The regression model derived from this study illustrates the relationship between Environmental, Social, and Governance (ESG) variables and the financial performance of manufacturing companies listed on the Indonesia Stock Exchange (IDX). The equation:

Y = -0.8590 - 1.3595*X1 + 11.4701*X2 + 4.1155*X3

Indicates that when all independent variables are equal to zero, the baseline value of financial performance is -0.8590. The coefficient for X1 (Environmental) is -1.3595, suggesting that a one-unit increase in environmental performance decreases financial performance by 1.3595 units, indicating a negative relationship. Conversely, X2 (Social) has a positive coefficient of 11.4701, meaning that a one-unit increase in social performance enhances financial performance by 11.4701 units, demonstrating a significant positive impact. Similarly, X3 (Governance), with a coefficient of 4.1155, indicates that a one-unit improvement in corporate governance increases financial performance by 4.1155 units.

These results confirm that social and governance aspects have a substantial positive impact on financial performance, while the environmental aspect exerts a negative influence, possibly due to the costs associated with environmental initiatives.

Tabel 3 Hypothesis Testing

Hipotesis	Pernyataan	Koefisien	Sig	Keterangan
H1	*Environmental, Social, and Governance have a positive effect on Financial Performance.*	15.028	0.000	The Data Supports the Hypothesis.
H2	*Environmental has a positive effect on Financial Performance.*	-1.359	0.151	The Data Does Not Support the Hypothesis.
H3	*Social has a positive effect on Financial Performance.*	11.470	0.000	The Data Supports the Hypothesis.

H4	*Governance has a positive effect on Financial Performance.*	4.115	0.000	The Data Supports the Hypothesis.

In this study, the hypothesis testing results show that the significance value of the Environmental variable has no effect on financial performance. The significance value for Environmental is 0.151, which is greater than 0.05, indicating no influence of Environmental on financial performance. Meanwhile, for the Social and Governance variables, the significance value for Social is 0.000, which is less than 0.05, indicating that Social has an impact on financial performance. Similarly, the significance value for Governance is 0.000, which is also less than 0.05, indicating that Governance influences financial performance. The Adjusted R-squared value is 0.737 or 73.7%. Therefore, it can be concluded that there is an effect from the first, third, and fourth hypothesis tests, with the total impact of all variables on financial performance being 73.7%.

The influence of Environmental, Social, and Governance (ESG) has a positive effect on financial performance.

Based on the results above, it shows that Environmental, Social, and Governance positively affect financial performance. This is supported by the finding that Environmental, Social, and Governance variables simultaneously influence financial performance. Environmental impacts financial performance; as the Environmental score increases, financial performance improves, and vice versa, thus affecting financial performance. Social also influences financial performance. The higher the Social ratio, the more the company is able to provide greater benefits to shareholders, and vice versa, which affects financial performance. The Governance ratio impacts financial performance as well.

The signaling theory suggests that companies can improve their perception and reputation in the eyes of stakeholders by disclosing positive information such as ESG, which can influence decisions made by these stakeholders. The legitimacy theory posits that corporate performance can be affected by adherence to societal standards; comprehensive ESG disclosures may not yet have fully enhanced the company’s legitimacy within society. According to stakeholder theory, the support and trust of stakeholders affect corporate performance. In this context, corporate performance can improve in the eyes of stakeholders when information is fully disclosed through ESG. This leads to the implementation of strong ESG practices that can generate long-term value and profitability.

Previous research by Pasquini and Sahut indicates a positive impact of ESG disclosures (Environmental, Social, and Governance). This is in line with the findings of Junius et al. (2020), which suggest that the higher the level of ESG disclosure, the better the company’s financial performance. The study conducted by Sharma et al. (2022) also supports this finding, stating that comprehensive ESG disclosure has a significant positive relationship with corporate financial performance. Based on this perspective, the comprehensive disclosure of environmental, social, and governance aspects can enhance a company’s financial performance in the eyes of stakeholders, including investors and the general public.

The influence of Environmental factors on financial performance.

Based on Table T, Hypothesis 2 regarding Governance in this study shows that the Governance variable does not have an impact on financial performance. The absence of the effect of environmental disclosure on a company’s financial performance can be explained through the company’s investments in environmental-related projects. Companies allocate resources to achieve social and environmental goals, such as building waste management facilities, reducing carbon emissions, and decreasing pollution, as well as other activities supporting environmental cleanliness around the company. As a result, companies face increased costs, reduced profitability, and a decline in competitive advantage.

Stakeholder theory emphasizes that focusing on environmental interests may lead to a trade-off with the short-term financial interests of shareholders. This combination of perspectives explains why a company’s environmental efforts can negatively impact financial performance, especially in the short term, even though they may yield long-term benefits that have not yet been reflected in conventional financial metrics. According to stakeholder theory, the short-term financial interests of shareholders may be more important than environmental concerns. This perspective explains why a company’s environmental efforts often interfere with short-term financial performance. Investments in environmental initiatives, such as emissions reduction or the use of renewable energy, may increase operational costs and reduce profitability. However, the long-term benefits of these efforts, such as improved reputation, customer satisfaction, and regulatory compliance, are not always reflected in conventional financial metrics. Therefore, despite the potential for sustained benefits, the negative effects seen in current financial reports may create a conflict between shareholders' financial interests and the achievement of environmental goals in the short term.

The findings of this study are in line with Minggu et al. (2023), Rao et al. (2023), and Saygili et al. (2023), whose research indicates that environmental performance does not affect financial performance. This study's findings contradict the research of Ramírez-Orellana et al. (2023), which found that environmental performance positively influences financial performance.

The influence of Social factors on financial performance.

Based on the results from Table T, Hypothesis 3 determines that Social factors positively affect financial performance, a widely accepted conclusion due to the positive correlation between social performance and financial performance. High social performance disclosure leads to an improvement in a company’s financial performance, as it enhances public and consumer trust in the company, thereby increasing workforce loyalty and morale due to the company’s strong social performance. Companies can improve their image in the eyes of consumers by participating in social activities such as donating to orphanages or conducting social services. As a result, consumers are more inclined to purchase the company’s products, increasing demand, which, in turn, boosts profit and financial performance. The higher the social performance disclosure index, the better the company’s overall performance. This is because an increased social performance disclosure index indicates that social efforts positively impact the company’s profits (Zahroh & Hersugondo, 2021a). Good social efforts enhance the company’s reputation, which directly affects both social and financial performance. A company’s transparency about its social performance also encourages better financial performance.

This study is supported by legitimacy theory, which suggests that companies that meet societal expectations in their strategies are considered to strengthen their legitimacy. Companies that implement responsible practices have the ability to fulfill their social responsibilities in line with societal perceptions. Reducing legitimacy tensions helps businesses become more credible and maintain their presence within society. Therefore, businesses with good social performance are more likely to secure financial support and investments to support their growth and expansion. In this way, high social performance disclosure can assist businesses in generating revenue in the best possible way.

Previous research by Chouaibi et al. (2022), Rao et al. (2023), and Liu et al. (2022) consistently indicates a strong correlation between a company’s social performance and its financial performance. They found that businesses demonstrating strong social performance through corporate social responsibility efforts, such as environmental sustainability, employee welfare, and community contributions, can gain legitimacy from society and stakeholders. In turn, this legitimacy enhances the company's financial performance. In other words, financial performance improves as a result of fulfilling social responsibilities, which can be seen through indicators such as profitability, stock value, and market competitiveness. This study emphasizes that to achieve long-term success, business strategies and social responsibilities must be integrated.

The influence of Governance on financial performance.

Based on the results from Table T, the findings show that Hypothesis 4, which posits that Governance positively influences the financial performance of companies, is supported. Corporate governance is a critical aspect of a company's regulation and management to ensure accountability, transparency, and sustainability in decision-making. Good governance fosters trust among shareholders, investors, and business partners, strengthens relationships with stakeholders, and supports operational stability. Furthermore, effective governance enhances operational efficiency, thereby improving the company's reputation, which in turn boosts both profits and financial performance.

Signal theory explains that the implementation of good governance sends a positive signal to the market regarding the quality of management and the company's prospects, which can increase market value and financial performance. Additionally, good governance enhances the overall operational efficiency of the company and improves external relationships. Proper governance enables more structured, rational, and data-driven decision-making processes, allowing companies to identify and manage risks more effectively. Furthermore, it provides the company with an opportunity to optimize their resources—financial, human, and technological—thereby allowing for more efficient and effective implementation of business strategies.

Previous research by Naeem et al. (2022), Zahroh & Hersugondo (2021), and Saygili et al. (2022) has demonstrated that good governance collectively contributes to improved financial performance by ensuring the achievement of business objectives that are focused and sustainable. High levels of governance disclosure indicate that companies maintain healthy financial performance, as it maximizes oversight functions and keeps operational activities safe and controlled, thereby positively impacting financial performance and serving as a critical foundation for long-term growth and success. Therefore, it can be concluded that there is a positive influence of governance on financial performance.

CONCLUSION

This study highlights the importance of understanding the factors influencing financial performance in manufacturing companies. The research shows that environmental factors do not have a significant impact on financial performance, as the costs associated with meeting environmental standards can reduce profits. On the other hand, social practices and governance have a positive effect on financial performance, indicating that practices such as corporate social responsibility and effective governance can enhance operational efficiency and build investor trust. The implementation of strong corporate governance and social responsibility is crucial for improving financial performance, building trust with stakeholders, and achieving greater sustainability and company value.

In this study, the coefficient of determination (R2) test table shows an Adjusted R-squared value of 0.737 or 73.7%, while the remaining 26.3% is influenced by other variables not included in this study, such as company size, liquidity, management quality, and capital structure.Future research is expected to address the limitations identified in this study in order to achieve better results. Future studies are also recommended to extend the period of analysis to examine the long-term effects of environmental, social, and governance (ESG) variables on financial performance. Additionally, it is suggested to include other variables that may affect financial performance, such as company size, liquidity, management quality, and capital structure. Larger companies may have more profitable investment opportunities, which can significantly impact their financial performance.

This research has important implications for companies, investors, and regulators, all of whom can benefit significantly from focusing on improving performance in environmental, social, and governance (ESG) aspects. Companies can enhance their financial performance by implementing effective policies in these areas, which not only improve their reputation but also increase operational efficiency, reduce risks, and create long-term, sustainable value. For investors, the findings of this study provide guidance on selecting more profitable investments by focusing on companies that demonstrate strong ESG performance, which often offer more stable and profitable returns. Meanwhile, regulators can use the findings of this research to formulate and implement regulations that support the enhancement of environmental and social responsibility practices, which in turn can create a more transparent, accountable, and sustainable business environment. Thus, this research can assist each party in promoting practices that are not only financially profitable but also contribute to social well-being and environmental protection.

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