

Chapter I

INTRODUCTION

1.1 Background

In recent years, Environmental, Social, and Governance (ESG) factors have gained significant attention from investors, regulators, and stakeholders worldwide. ESG considerations encompass a range of sustainability metrics, including environmental impact, social responsibility, and corporate governance practices. These factors have become increasingly crucial for businesses seeking to enhance their long-term value creation and mitigate various risks associated with environmental, social, and governance issues.

The environmental criteria encompass a company's interaction with the physical environment. In contrast, ecological issues encompass greenhouse gas emissions, biodiversity loss, pollution, and contamination, as well as compliance with regulations related to carbon emissions and renewable energy. On the other hand, social criteria encompass a company's impact on communities and other stakeholders, including labor practices, community displacement, human rights, health, safety, and financial inclusivity. Governance criteria are related to corporate leadership, executive compensation, audits, internal controls, and shareholder rights, while issues include corruption, reputation, management effectiveness, and compliance with applicable regulations. (Sakti, 2024).

In recent years, Environmental, Social, and Governance (ESG) factors have gained significant attention from investors, regulators, and stakeholders worldwide. ESG considerations encompass a range of sustainability metrics, including environmental impact, social responsibility, and corporate governance practices. These factors have become increasingly crucial for businesses seeking to enhance their long-term value creation and mitigate various risks. It. In Indonesia, as in many other countries, integrating ESG principles into corporate strategies has become a

pressing concern. The Indonesian market, with its diverse economic landscape and significant environmental and social challenges, presents both opportunities and challenges for companies aiming to improve their ESG performance. The result is evident in the ESG score, as assessed by Morningstar Sustainalytics and reported by the Indonesia Stock Exchange (IDX) in its sustainability report.

In the contemporary landscape of global finance, ESG factors have emerged as pivotal determinants of corporate success and sustainability. With growing societal consciousness and regulatory frameworks emphasising responsible corporate behaviour, investors are increasingly scrutinising companies' ESG practices as integral components of their investment decisions. This paradigm shift highlights the significance of understanding the complex relationship between ESG performance and financial outcomes. Understanding the impact of ESG scores on economic performance is crucial for businesses operating in Indonesia. By analysing the relationship between ESG scores and financial metrics such as profitability, return on investment, and stock performance, companies can gain insights into the effectiveness of their sustainability initiatives and identify areas for improvement.

Indonesia ranked 36th out of 47 global capital markets in the 2021 IBCSD ESG Index, with 40% of companies still lacking ESG awareness. In Membertalk#8 by IAP2 Indonesia, according to expert Herry Ginanjar IAP2 (2022), identified key ESG challenges, including lack of expertise, unpreparedness, resource constraints, high consultant costs, complexity, and uncertainty on where to start. Meanwhile, Hasan Fawzi IAP2 (2022), Director of Development at the Indonesia Stock Exchange, noted that companies adopting ESG practices experience higher profits and better stock performance, attracting investors. According to (Han et al., 2022), ESG principles form a framework integrating environmental, social, and governance factors, serving as key standards for investors to evaluate corporate behavior and financial performance. These aspects play a crucial role in investment analysis and decision-making.

ESG implementation in Indonesia has grown rapidly, with companies increasingly recognizing its importance. PT Unilever Indonesia Tbk leads in environmental and social initiatives, such as plastic waste reduction and farmer empowerment, while PT Bank Rakyat Indonesia (Persero) Tbk (BRI) is known for its inclusive corporate governance and social programs. A survey of 2,000 companies found that 35% understand ESG principles, while the rest need guidance, especially in achieving Net-Zero goals (Penerapan Integrasi ESG di Indonesia, 2024). ESG plays a crucial role in sustainable development by reducing environmental impact, improving community welfare, fostering economic inclusion, and enhancing governance transparency, aligning with the UN's 2030 Agenda and Indonesia's National Development Plans.

This study seeks to delve deep into the impact of ESG scores on operational and financial performance within the context of the Indonesian market. The financial performance is measured by ROE and operational performance is measured by ROA. The impetus behind conducting this research arises from curiosity while the environmental benefits of ESG are apparent and widely acknowledged, its tangible impact on a company's profitability remains uncertain.

Understanding these dynamics is imperative for stakeholders ranging from investors and financial institutions to policymakers and corporate leaders. By unraveling the intricate relationship between ESG score on operational and financial outcomes, this study aims to provide actionable insights that can inform strategic decision-making, foster sustainable business practices, and ultimately drive positive societal and economic outcomes in Indonesia.

The prior research was conducted by Sanjaya & Sianturi (2024) ESGD have a negative and significant effect on market reaction and investors in the capital market react positively to ESGD. According to Velte (2017), demonstrates that ESG has a positive effect on firm value and profitability for firms in Germany. The author also finds that governance has a significant effect on market and firm performance (Yoon et al., 2018). Other than that research that conducted by Kalia

& Aggarwal (2022) found that there is a significant relationship between ESG activities and firm performance. Research conducted by (Aboud & Diab, 2018) found that ESG score there is a positive relationship between ESG ratings and both the market and the financial performance of firms. examine the link between ESG ratings and market value in Korea Similarly. According Landi & Sciarelli (2018), focus on 54 listed Italian companies from 2007 to 2015 and report a negative relationship between their ESG scores and financial performance. Other research also stated that ESG scores are negatively associated with multilatinas' Financial Performance according to random effect regression (Duque-Grisales & Aguilera-Caracuel, 2021). Recognizing these variables as potential influencers, this research aims to address this gap and explore the contemporary dynamics of how ESG may impact a company's profitability. Problem Questions and the objectives of this research will be detailed in the following section.

1.2 Research Questions

- 1) Does ESG scores have a positive impact on operating performance in Indonesia?
- 2) Does Environment scores have a positive impact on operating performance in Indonesia?
- 3) Does Social scores have a positive impact on operating performance in Indonesia?
- 4) Does Governance scores have a positive impact on operating performance in Indonesia?
- 5) Does ESG scores have a positive impact on financial performance in Indonesia?
- 6) Does Environment scores have a positive impact on financial performance in Indonesia?
- 7) Does Social scores have a positive impact on financial performance in Indonesia?

- 8) Does Governance scores have a positive impact on financial performance in Indonesia?

1.3 Research Objective

This study will give empirical evidence that ESG scores, environment score, social score and governance score have a positive impact on operational and financial performance in Indonesian companies' specialist in non-cyclical.

1.4 Research Contributions

This research makes three key contributions to the understanding of ESG (environmental, social, and governance) integration within the Indonesian context:

a) Theory Contribution

First, the theoretical contribution lies in advancing the academic discourse on the relationship between ESG performance and firm outcomes. By grounding the analysis in stakeholder theory and sustainable finance frameworks, the study deepens our understanding of how ESG factors influence both operational and financial performance. It adds to the growing body of literature by applying these theoretical lenses to an emerging market setting, where ESG integration is still evolving.

b) Empirical Contribution

The empirical contribution stems from the study's focus on Indonesia—an emerging economy with unique institutional, cultural, and regulatory characteristics. By analyzing firm-level ESG data and financial metrics, this research provides robust empirical evidence on the link between ESG scores and performance outcomes in a non-Western context. It offers new insights into how local dynamics affect the ESG–performance relationship, thus filling a gap in existing global ESG literature.

c) Regulatory Contribution

The regulatory and practical contribution is directed toward policymakers, regulators, and corporate decision-makers. The findings offer actionable insights that can guide the development of policies and regulatory frameworks to promote ESG adoption and transparency in Indonesian businesses. The study highlights the role of ESG in enhancing long-term value creation and provides a compelling case for integrating ESG considerations into corporate governance, investment strategies, and national sustainability agendas.

1.5 Writing Structure

CHAPTER I	INTRODUCTION
	Consists of research background, research question, research objective and contribution.
CHAPTER II	LITERATURE REVIEW
	Consists of theories and literature as the basis and hypothesis to support this study. First, the chapter will introduce the literature review. Second, past research that has been done on the same or similar topic by other scientists is the evolution of hypothesis.
CHAPTER III	RESEARCH METHODOLOGY
	Consists of research type and source data, unit analysis, object of research, sample of the research, research variable, data collection and analysis data.
CHAPTER IV	RESEARCH RESULTS AND DISCUSSION
	Consists of descriptive statistics, the result of data analysis, the result of hypothesis testing, then the discussion and analysis.
CHAPTER V	CONCLUSION

	Consists of conclusion research, research limitation and suggestion for further research.
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