

Chapter II

LITERATURE REVIEW

2.1 Stakeholder Theory

Stakeholder theory posits that organizations should consider the interests of all stakeholders, not just shareholders, in their decision-making processes. This theoretical perspective highlights the interconnectedness between a company and its stakeholders, including employees, customers, communities, and the environment. As such, stakeholders are seen as entities who can significantly impact, and are impacted by, a company's operations and performance (Mahajan et al., 2023).

Within the context of ESG integration, stakeholder theory underscores the importance of considering the interests and concerns of various stakeholders when formulating ESG strategies and initiatives. Companies are increasingly recognizing that addressing ESG issues is not only a matter of regulatory compliance but also a means to effectively manage relationships with stakeholders and enhance long-term value creation (Martiny et al., 2024).

Engaging with stakeholders is a fundamental aspect of ESG integration, as it allows companies to understand stakeholder expectations, identify material ESG issues, and develop appropriate responses. Effective stakeholder engagement enables companies to build trust, mitigate risks, and capitalize on opportunities related to ESG issues (Kulova & Alexieva, 2023).

Research indicates a positive relationship between stakeholder engagement and ESG performance, outcomes (Wang, 2024). By incorporating stakeholder feedback into ESG strategies, companies can enhance their legitimacy, reputation, and overall sustainability performance (Lee & Raschke, 2023). ESG information can enhance public trust and improve a company's reputation, giving it a competitive edge. This boost in public trust also contributes to higher company value and better market performance (Suttipun & Yordudom, 2022).

2.2 Economic Behavioral theory

According to Beerbaum and Puaschunder (2019), behavioral economic theory highlights that investors often rely on heuristics—simplified decision-making rules—especially under conditions of uncertainty or complexity. Witynski (2022) further emphasizes that investors are frequently driven by short-term gains rather than long-term benefits, which can lead to irrational or suboptimal financial decisions. This short-termism presents a fundamental challenge in the context of ESG (Environmental, Social, and Governance) disclosure, which is inherently oriented toward long-term value creation, risk management, and sustainability. As a result, investors influenced by behavioral biases may misinterpret or undervalue ESG disclosures, viewing them as non-essential or even detrimental to immediate financial performance.

This misalignment is particularly pronounced in emerging markets such as Indonesia, where ESG awareness, regulatory enforcement, and investor education are still evolving. Companies that engage in transparent ESG reporting may be penalized by market participants who fail to recognize the long-term strategic benefits of such practices. Consequently, firms may be discouraged from adopting comprehensive ESG initiatives due to fear of short-term market backlash. Addressing this issue requires targeted policy interventions—such as strengthening ESG disclosure standards, promoting long-term investment mindsets, and enhancing investor education—to realign market behavior with sustainable development goals and foster broader acceptance of ESG as a driver of long-term financial and societal value.

2.3 Environmental Social Government (ESG)

ESG scores offer a comprehensive evaluation of a company's ESG performance, based on reported data related to the ESG pillars and incorporating ESG controversies sourced from global media. The primary aim of this score is to

adjust the ESG performance score by factoring in negative media coverage. It achieves this by including the impact of significant, material ESG controversies in the overall ESGC score.

For companies involved in ESG controversies, the ESGC score is determined as the weighted average of the ESG scores and the ESG controversies score for each fiscal period, with recent controversies included in the latest completed period. If a company is not involved in any ESG controversies, the ESGC score will be the same as the ESG score.

The Indonesia Stock Exchange (IDX) collaborates with Morningstar Sustainalytics for conducting ESG evaluations. Only assessments conducted by accredited agencies are showcased by IDX. ESG assessment plays a vital role in evaluating companies' ESG practices. Hence, IDX persistently promotes long-term sustainable investments and enhances ESG standards in the Indonesian capital market by partnering with ESG assessment firms and conducting evaluations of listed companies.

For now, ESG score can be accessed in their sustainability report or by using ESG Intelligent (ESG Intelligence, 2022). ESG score is difference compared to ESG risk rating. Where ESG score using nominal of zero until one. But ESG risk rating using nominal from start from one until fourth where fourth was the best nominal in here. In general, ESG score is a comprehensive measure of a company's performance across environmental, social, and governance dimensions. It evaluates how well a company is managing its ESG factors and aims to provide a holistic view of its overall ESG practices. ESG scores are typically derived from reported data and various metrics that reflect a company's efforts and achievements in these areas.

An ESG risk rating, on the other hand, assesses the level of risk a company faces due to its ESG practices or lack thereof. It focuses on the potential negative impact of ESG factors on a company's financial performance and long-term sustainability. The ESG risk rating considers the likelihood and severity of adverse

events related to environmental, social, and governance issues, emphasizing the vulnerabilities and exposures that could pose financial risks. Following the ESG score assessment, listed companies are categorized into one of four groups based on (LSEG, 2023) :

Table 2.1 ESG, Environment, Social, and Governance Score Range

E,S,G and ESG score range	Category	Description
0.0 <= score <= 0.083333 0.083333 < score <= 0.166666 0.166666 < score <= 0.250000	D – D D +	Score indicates poor relative ESG, environment, social, and governance performance and insufficient degree of transparency in reporting material ESG data publicly.
0.250000 < score <= 0.333333 0.333333 < score <= 0.416666 0.416666 < score <= 0.500000	C – C C +	Indicates satisfactory relative ESG, environment, social, and governance performance and moderate degree of transparency in reporting material ESG data publicly.
0.500000 < score <= 0.583333 0.583333 < score <= 0.666666 0.666666 < score <= 0.750000	B – B B +	Indicates good relative ESG, environment, social, and governance performance and above- average degree of transparency in reporting material ESG data publicly.
0.750000 < score <= 0.833333 0.833333 < score <= 0.916666 0.916666 < score <= 1	A – A A +	‘A’ score indicates excellent relative ESG, environment, social, and governance performance and high degree of transparency in reporting material ESG data publicly.

2.4 Operational Performance

Emphasizes factors like operational efficiency, asset utilization, and profit margins that influence ROA. Companies with streamlined operations, effective asset use, and healthy profit margins typically boast higher ROA. ROA can be used to compare the profitability of different companies in the same industry. ROA is a commonly utilized metric in assessing company performance, reflecting the extent to which a company can generate profits from its assets. This metric has been extensively applied in prior research studies Duque & Caracuel (2021) ROA is calculated by dividing net income by average total assets. A higher ROA indicates better efficiency in using assets to generate profit, while a lower ROA suggests room for improvement.

2.5 Financial Performance

Financial performance is a pivotal aspect examined in this research, typically evaluated through analysis of a company's financial statements. Return on Equity (ROE) is another vital metric employed to gauge the efficiency of a company in generating profits from its shareholders' equity (Buallay, 2019).

2.6 ESG on Operational and Financial performance

The interplay between Environmental, Social, and Governance (ESG) factors and a company's operational and financial performance, as measured by Return on Assets (ROA) and Return on Equity (ROE), is a captivating area of ongoing research with promising implications. While the exact cause-and-effect relationship remains under debate, a growing body of evidence suggests a positive correlation, potentially leading to improvements in both operational efficiency and financial health.

Proponents of a positive ESG-performance link argue that strong environmental practices can significantly impact ROA. By reducing waste and

energy consumption, companies can minimize costs associated with production and resource utilization. Additionally, prioritizing social responsibility initiatives that enhance employee well-being can boost morale and reduce turnover, leading to a more productive and engaged workforce. This translates directly to improved operational efficiency, which can positively influence ROA. Furthermore, strong governance practices can enhance risk management and corporate oversight, potentially reducing disruptions and legal issues that could negatively affect operational performance.

The financial benefits of strong ESG practices can also contribute to a company's ROE. Increased operational efficiency often leads to higher profitability, directly impacting ROA and contributing to a higher ROE. Additionally, a strong ESG profile can unlock access to capital from investors increasingly focused on sustainability, improving a company's financial resources and potentially boosting ROE. Reduced regulatory risk and fines associated with responsible practices contribute to a company's financial stability, further bolstering ROE. Finally, a positive brand reputation built on responsible practices can attract and retain customers, leading to higher sales and ultimately a higher ROE.

2.7 Previous Study

ESG practices, while not always guaranteed, offer numerous potential benefits including operational efficiency, risk management, cost reduction, and enhanced profitability and shareholder value. Several studies have shown that implementing ESG initiatives can lead to reduced corporate financing costs. Tommaso & Thornton (2020) increased revenue, and higher returns (Almeyda & Darmansya, 2019). Moreover, engaging in ESG activities has been found to lower corporate risk-taking behavior and mitigate firm risk, thereby ensuring risk reduction (Zhao et al., 2018). Comparative studies within industries have revealed that stocks of firms incorporating ESG factors exhibit lower volatility and reduced risk of future stock price declines (Kumar et al., 2016). Additionally, firms engaging in ESG activities are observed to face lower tail risk and idiosyncratic risk (Sassen

et al., 2016). In line with resource dependence theory, ESG activities serve as valuable resources that can benefit firms.

Conversely, there is evidence suggesting a negative impact of ESG on firm performance (Duque-Grisales & Aguilera-Caracuel, 2021). Studies adopting an agency theory perspective explain this negative relationship by positing that ESG practices can reduce profits (Barnea & Rubin, 2006) and transfer resources away from maximizing shareholder wealth. Managers may prioritize ESG investments to enhance their reputation at the expense of shareholders, potentially leading to higher firm costs and economic disadvantages (B. Yoon et al., 2018). Overall, while ESG activities offer potential benefits, they may also entail costs and risks that need to be carefully considered in strategic decision-making processes.

Interestingly, previous research has yielded inconsistent results, making it challenging to determine the true impact of ESG on company financial performance. Previous studies predominantly focused on using Return on Equity (ROE) or Return on Assets (ROA) as indicators of operational and financial performance. Recent studies suggest that employing both ROA and ROE simultaneously can provide a more comprehensive assessment of operational and financial performance. Moreover, prior literature predominantly relied on data collected before the onset of the COVID-19 pandemic, despite the pandemic's significant impact on financial performance. This highlights existing gaps in literature, including conflicting findings, differences in timeframes, and variations in operational and profitability metrics.

Table 2.2 Past studies

Number	Name	Title	Research result
1.	Tommaso and Thornton, 2020	Do ESG scores effect bank risk taking and value? Evidence from European banks	ESG activities reduced corporate financing costs.

2.	Almeyda and Darmansya, 2019	The influence of environmental, social, and governance (ESG) disclosure on firm financial performance	ESG score increased revenue and higher return.
3.	Zhao et al., 2018	ESG and corporate financial performance: empirical evidence from China's listed power generation companies	Performing ESG activities ensured firm risk reduction and reduced corporate risk-taking behavior.
4.	Buallay, 2018	Is sustainability reporting (ESG) associated with performance? Evidence from the European banking sector	a positive association between ESG (Environmental, Social, and Governance) reporting and bank performance. Specifically, banks with higher levels of ESG disclosure tend to have better financial performance, suggesting that sustainability efforts can enhance profitability and overall performance in the banking sector.
5	Aggarwal, 2022	Examining impact of ESG score on financial performance of healthcare companies	It provides evidence of a significant relationship between ESG activities and firm performance.

6	Sassen et al., 2016	Impact of ESG factors on firm risk in Europe	Firms that perform ESG activities also face lower tail risk, idiosyncratic risk
7	Siew-peng Lee., 2022	Environmental, social and governance (ESG) practices and financial performance of Shariah-compliant companies in Malaysia	Studies find that ESG companies outperform non-ESG companies in all performance measures. We also find that ESG companies tend to be larger in asset size and sales compared to non-ESG companies. However, we find no difference in performance between Shariah and non-Shariah firms for ESG as well as for non-ESG companies
8	Brammer et al., 2006	Corporate social performance and stock returns: UK evidence from disaggregate measures	Studies find evidence of a negative impact of ESG on firm performance
9	Duque-Grisales and Aguilera-Caracuel, 2021	Environmental, social and governance (ESG) scores and financial performance of multinationals: moderating effects of geographic international	Studies find evidence of a negative impact of ESG on firm performance

		diversification and financial slack	
10	Barnea and Rubin, 2010	Corporate social responsibility as a conflict between shareholders	Negative relationship between ESG and firm performance, suggesting that performing ESG reduces profits and transfers resources
11	Yoon et al., 2018	Does ESG performance enhance firm value? Evidence from Korea	Performing ESG activities could lead to high firm costs and are an economic disadvantage
12	Setiani 2023	The Impact of ESG Scores on Corporate Financial Performance: Moderating Role of Gender Diversity	Shows that ESG scores have a negative and significant relationship to corporate financial performance
13	Sanjaya & Sianturi, 2024	Environmental, Social, and Governance Disclosure on Market Performance in Indonesia	Shows that individuals that investors in the capital market react positively to ESGD
14	Sanjaya & Yoelencia, 2024	Carbon Performance and Information Disclosure on Market-Based and Accounting-Based Performance	Carbon Performance does not influence both economic performance and operational performance, but Carbon Performance positively

			significantly influences financial performance.
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2.8 Hypothesis Development

2.8.1 ESG Score on Operational Performance

Environmental, Social, and Governance scores are increasingly recognized as important indicators of a company's sustainability and ethical impact. Operational performance, often measured by financial metrics such as Return on Assets (ROA), reflects the efficiency with which a company utilizes its assets to generate earnings. The relationship between ESG performance and operational performance has become a critical area of study, as companies with higher ESG scores may benefit from enhanced reputation, operational efficiencies, and reduced risks, potentially leading to better financial outcomes.

Several theories underpin the potential relationship between ESG scores and operational performance. Stakeholder Theory suggests that companies engaging in responsible ESG practices are more likely to gain stakeholder trust and loyalty, leading to improved operational performance. This theory is in line with the results of the studies conducted by which state that ESG has positive influence on operational. Other than that company that doing ESG activity in their business will have a good response from the community and a lot of respect that they earn will incase on their production sell, etc. Based on the explanation above, the hypothesis is as follows:

H_{a1} : ESG score of a firm positively impacts Operating performance.

H_{a2} : Environment score of a firm positively impacts Operating performance.

H_{a3} : Social score of a firm positively impacts Operating performance.

H_{a4} : Governance score of a firm positively impacts Operating performance.

2.8.2 ESG score and Financial Performance

Environmental, Social, and Governance (ESG) scores are increasingly viewed as critical indicators of a company's sustainability practices and ethical impact. Financial performance, commonly measured by Return on Equity (ROE), reflects a company's ability to generate profits from shareholders' equity. The relationship between ESG performance and financial performance is of significant interest, as companies with higher ESG scores might experience better financial outcomes due to improved operational efficiencies, risk management, and stakeholder relationships.

Several theories suggest a positive relationship between ESG scores and financial performance. Stakeholder Theory posits that companies with strong ESG practices are more likely to build trust and loyalty among stakeholders, leading to better financial performance. This theory is in line with the results studied conducted by (Ahmad, Mobarek, & Roni, 2021) which state that ESG has positive influence on financial performance. ESG take big part in here because with the increase ESG activity the company will have and increase in their financial performance, the practice of ESG encourage efficiency in operational and stimulate them to have more financial income. with that they can develop the business, pay out dividend, etc. Based on the explanation above, the hypothesis is as follows:

H_{a5} : ESG score of a firm positively impacts financial performance.

H_{a6} : Environment score of a firm positively impacts financial performance.

H_{a7} : Social score of a firm positively impacts financial performance.

H_{a8} : Governance score of a firm positively impacts financial performance.

2.9 Framework

The conceptual framework is the theoretical relationship between research variables observed or measured by the research conducted. In this research there is independent Variable, dependent variables, and control variable.

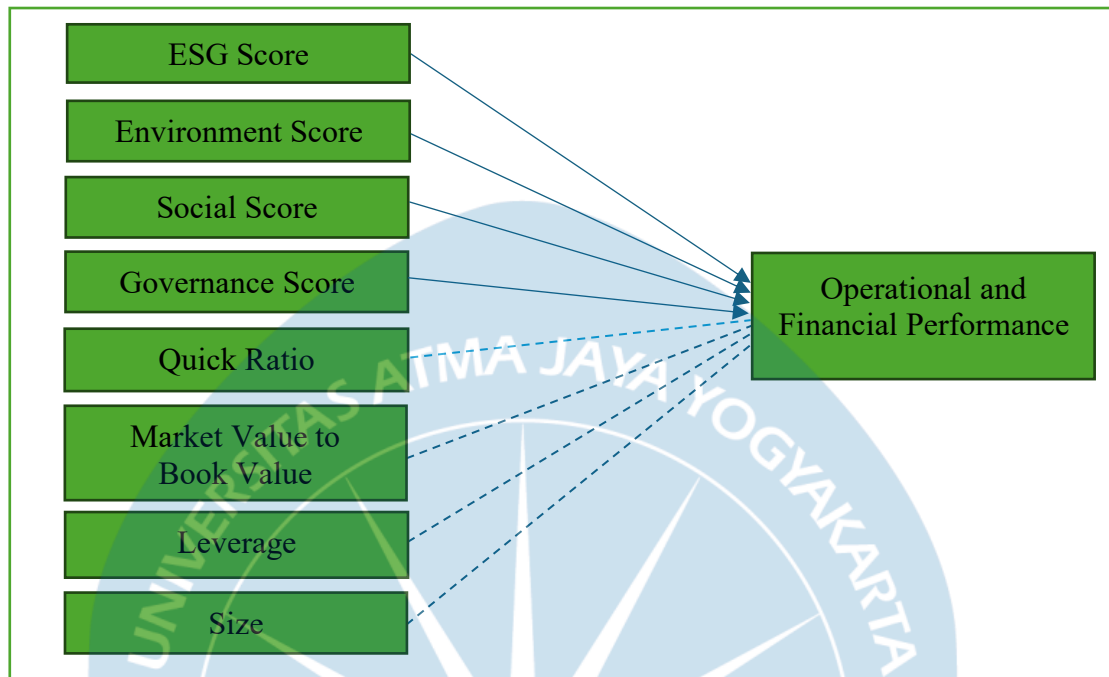


Figure 2.1 Framework