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Does ESG Affect The Firm Value?

Agustin Palupi[1]

[1]Trisakti School of Management, Jl. Kyai Tapa No.20, Tomang, Kec. Grogol petamburan, 11440, Jakarta, Indonesia

ABSTRACT

Objective - As the concept of sustainability develops in the industrial world, stakeholders are compelled to consider ESG performance when measuring company value. A company needs to increase its value and demonstrate its sustainability capabilities by publishing sustainability reports on ESG factors. This research aims to inquire whether ESG affects the firm's value.

Methodology/Technique – The causality research is analyzed with Eviews using ASEAN panel data from 2019-2021 to measure the effect of ESG on firm value with a total of 738 firm years of data.

Findings - Environmental performance is associated with high ecological costs in developing nations and is a burdensome additional expense that will deteriorate the company's financial condition. Disclosure of nonfinancial information jeopardizes the creation of company value, resulting from meeting the demands of stakeholders imposed on the company, thereby causing other agency conflicts. The relatively low level of investor confidence in the signal contributes to ESG performance that lowers the company's market value. Most investors respond negatively to these signals, assuming that the activities disclosed in ESG reporting are too costly and detrimental to their interests. They could be more enthralling in investing, decreasing market demand, and reducing the company's value.

Novelty - This study explains the determinants of firm value from ESG scores and separate ESG scores in the ASEAN market.

Type of Paper: Empirical.

JEL Classification: F64, L50, Q25, G02, G39, M14

Keywords: ESG, Firm value, Environment score, Social score, Governance score, Sustainability

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1. Introduction

As the concept of sustainability develops in the industrial world, stakeholders are compelled to consider ESG performance when measuring company value. Increasing the company's value and demonstrating its sustainability capabilities is essential by publishing sustainability reports on environmental, social, and governance factors. It will be disclosed if the information increases the company's value (Verecchia, 1983). Investors are increasingly concerned about ESG transparency, so they need adequate, credible, reliable, and relevant ESG data for their investment decisions. Resources will be widely used to produce ESG reports that meet investors' expectations (Wong, 2017).

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* Corresponding author: Agustin Palupi
E-mail: palupiresearch@gmail.com
Affiliation: Trisakti School of Management, Jl. Kyai Tapa No.20, Tomang, Kec. Grogol petamburan, 11440, Jakarta, Indonesia

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Based on the 2015 CFA Institute research, stated that 27% of investors considered ESG in their analysis and investment decisions. Social and environmental responsibility disclosure requires much money and takes a long time (Arend & Brettel, 2010). Until now, no standard regulates the items of sustainability report disclosure that must be reported or the method of reporting that must be done. Clarkson (2008) stated that companies that have carried out suitable environmental activities will voluntarily disclose their performance because these disclosures impact reducing the company's cost of equity capital, and company value will increase. To analyze sustainability reports, Thomson Reuters ESG metrics were launched based on the GRI concept (Thomson Reuters, 2017). After evaluating the company's sustainability reports, Thomson Reuters developed the ESG Assessment. This statistical organization uses company-reported data to objectively and transparently examine company relatives. Although the ESG index is based on the GRI score, it is not synonymous with the GRI because the GRI sets reporting requirements from a company's point of view when planning CSR (Melinda & Wardhani, 2020). The standards contained in the GRI are included in the ESG assessment index issued by Thomson Reuters. However, the valuation included in the ESG index has been packaged more concisely in its indicators and adapted to the information needed from an investor's point of view. Many studies on ESG and firm value have been conducted in developed countries. This study examines how companies in developing ASEAN countries, which possess significant natural resources, may enhance their ESG performance by assessing the benefits of incorporating sustainability practices or the potential costs of not doing so. Specifically, this research seeks to provide empirical evidence on the impact of ESG performance on company value from 2019- 2021.

2. Literature Review

2.1 Signalling Theory

(Akerlof, 1970) proposed the signaling theory, which suggests that during a transaction, the parties involved possess varying levels of information, and this information holds value. The company considers it signals an essential thing that influences the investment decision assessment of parties outside the company. According to (Spence, 1978), the fundamental goal of corporate reporting is to communicate the value of a company to investors and analysts.

According to (Scott-Phillips et al., 2009), managers engage in signaling because the company is privy to information deemed relevant and appropriate for disclosure. Therefore, the manager discloses his information because it is unknown to external parties. Managers who are confident in the quality of their organization bear in mind that the costs associated with signaling will be more substantial for low-quality organizations. Managers engage in signaling to communicate information that is exclusive to their company and unknown to outside parties. This information is deemed pertinent and suitable for disclosure to influence external parties' assessment of the company's performance and capabilities. Signaling can take various forms, including revealing audit quality and company policies like accounting and dividend policies (Scott-Phillips et al., 2009). (Hamrouni et al., 2015) also stated that Voluntary disclosure is one of the relevant company-related research materials. Based on prior research, voluntary disclosure is associated with firm value.

2.2 ESG

ESG refers to non-financial data, and ESG evaluation is assessed through scores. ESG disclosures describe strategies for increasing accountability for corporate success and communicating with stakeholders (Weber, 2014). The ESG value of a company is an indicator of its ESG performance based on the information provided by the company. A higher ESG value indicates better ESG performance by the company. Information regarding ESG performance written and disclosed by companies in annual reports, sustainability

reports, and others are also one way for companies to manage or enhance their reputation in ESG. Thus, a company's reputation is expected to impact its value. The ESG report, as voluntary disclosure, still needs to have a standard disclosure standard. Several standards are commonly used in ESG reporting: the GRI Sustainability Report, SASB Sustainability Report, IIRC, CDSB Climate Disclosure, and CDB Global Environmental Score System. SASB and IIRC joined forces to form the Value Reporting Foundation.

2.3. Firm Value

Firm value is a company's achievement as measured by share price, influenced by the demand and supply of financial markets, and is a public assessment of company performance (Harmoni, 2009). (Konar & Cohen, 2001) conducted research that proved environmental aspects also influence a firm value in the industry. Tobin's Q formula assesses a company's worth by analyzing its potential for investment opportunities or growth prospects in state-owned businesses (Lang et al., 1996). This ratio reflects the most recent incremental return on investment calculations from the financial market

2.4. Hypothesis Building

ESG and Firm Value

Non-financial disclosures such as ESG are expected to become a social investment that can improve company performance. Based on (Fatemi et al., 2018), disclosure of ESG can reduce the company's valuation. Nonetheless, this study found that disclosure significantly moderates the harmful effects of ESG deficiencies and the positive effects of ESG strengths. (Aboud & Diab, 2018) conducted a study to examine the correlation between information disclosure and company value. They found a positive relationship between a company's index ranking and Tobin's Q-measured value. Similarly, (Yoon et al., 2018) concluded that good ESG performance is significantly and positively associated with company value in Korea. Their findings support prior research conducted in developed countries, indicating a positive influence of ESG theory on firm value. So, the first hypothesis is as follows:

H1: *ESG performance of the company positively impacts firm value.*

Environment Pillar and Firm Value

Considerations of the environmental performances such as resource consumption, carbon footprint, and innovation are factored into the calculation of the ESG Environment value. The better a company's environmental performance, as measured by the ESG metrics, the higher the value of environmental ESG performance. Numerous studies suggest that environmental performance positively impacts a company's reputation, revenue, and cost reduction. These studies also indicate that positive signals are sent to investors through announcements about environmental performance, which result in positive abnormal stock returns (Klassen & McLaughlin, 1996) (Jacobs et al., 2010) (Yadav, 2015). The company's environmental performance relates to how the company as an organization affects the ecosystem. Good resource management will impact good company performance (Newbert, 2008). There is a significant favorable influence between good company environmental performance on company value (Aboud & Diab, 2018) (Buallay, 2019) (Li et al., 2018). The opposite results describe a negative relationship in (Balasubramanian 2019) and (Fatemi et al., 2018) studies. So, the second hypothesis is as follows:

H2: *The company's environmental performance positively impacts firm value.*

Social Pillar and Firm Value

An ESG Social value refers to a company's social performance, encompassing various aspects such as workforce, human rights, product accountability, and community involvement. A higher social ESG performance value implies better social performance by the company. There is a growing demand from stakeholders for companies to mitigate the negative impact of their activities (Susilowati, 2013). It confirms that expanding the responsibilities in social and environmental aspects is mandatory for a company. They do have rights, obligations, and responsibilities to society. In general, increased long-term benefits and support for corporate continuity can be achieved by having social responsibility. Previous studies have found that environment and Tobin's Q positively correlate (Aboud & Diab, 2018) (Buallay, 2019) (Li et al., 2018) (Fatemi et al., 2018) (Alareeni & Hamdan, 2020)(Lopez-Toro et al., 2021). On the other hand, according to (Balasubramanian, 2019), there is also a negative relationship between the environment and company value. Based on this explanation, this study proposes the following hypothesis:

H3: *The company's social performance positively impacts firm value.*

Governance Pillar and Firm Value

The ESG Governance value reflects a company's corporate governance performance, which includes management, CSR strategy, and shareholders. A higher ESG score for governance indicates better corporate governance performance. Managers who have confidence in the quality of their company are likely to make disclosures in their sustainability reports to signal investors, in line with signaling theory. Companies with poor quality are likely to incur higher costs for signaling. Previous studies have shown that governance factors have a positive effect on Tobin's Q, including (Aboud & Diab, 2018), (Li et al., 2018) (Buallay, 2019), (Alareeni & Hamdan, 2020), and (López-Toro et al. 2021). Higher corporate governance performance values are associated with higher corporate values. However, governance transparency Tobin's Q, according to (Lee et al., 2018) and (Balasubramanian 2019). Based on this information, this study proposes the following hypothesis:

H4: *The company's governance performance positively impacts firm value.*

3. Research Methodology

This study aims to empirically test and prove the effect of ESG on firm value. The independent variable in this study is the company's ESG (environmental, social, governance) value. Each value of these components results from an assessment conducted by Thomson Reuters on the company's performance obtained from the information disclosed by the company in its financial and annual reports and obtained by the scoring method. The value of the environmental component in the ESG is indicated by three indicators: resource use, emission, and innovation. The value of the social component is indicated by four indicators, namely labor (workforce), human rights (human rights), product responsibility (product responsibility), and community (community). The dependent variable in this study is a company value, as measured by using the ratio of Tobin's Q. Control variables include sales growth, leverage (debt to equity ratio), and firm size (ln total asset). In this study, the population used is all countries in ASEAN from 2019 – 2021. The sampling method involved purposive sampling of companies in the non-financial industry, including banks, non-bank financial institutions, securities companies, insurance, mutual funds, and others, with the condition that they do not have a negative value on their equity. The study utilized a sample of public companies listed on each country’s stock exchange and have an ESG score rating from Thomson Reuters. This study used a panel data

regression model to test the research hypothesis that the independent variable affects the dependent variable. H1 is examined utilizing Model 1. While Model 2 is used to test H2, H3, and H4. The model is as follows:

Model 1:

$$\text{Tobin's } Q_{it} = \alpha_0 it + \beta_1 ESGit + \beta_2 GROWTHit + \beta_3 LEVit + \beta_4 SIZEit + \varepsilon it$$

Model 2:

$$\text{Tobin's } Q_{it} = \alpha_0 it + \beta_1 ENVit + \beta_2 SOCit + \beta_3 GOVit + \beta_4 GROWTHit + \beta_5 LEVit + \beta_6 SIZEit + \varepsilon it$$

Explanation:

Tobin's Q	: Firm value
ESG	: ESG score
ENV	: ESG *pillar environmental*
SOC	: ESG *pillar social*
GOV	: ESG *pillar governance*
GROWTH	: Sales growth
LEV	: *Leverage*
SIZE	: Firm Size
ε	: *error term*

The conceptual framework for this research is:

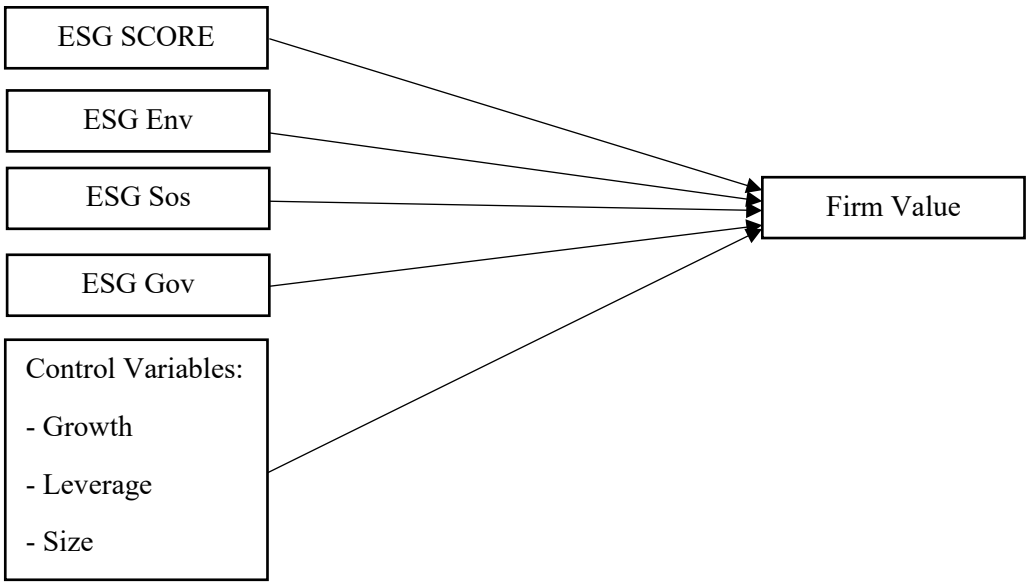


Figure 1. Conceptual Framework

4. Results and Discussion

Based on the sample criteria, the appropriate amount of data is 246 companies or 738 firm years.

Table 1 Descriptive Statistics

	N	Min	Max	Mean	Std. Deviation
TOBINSQ	738	8.0005	98.4650	2.2717	8.3808
ESGScore	738	6.4633	91.0334	52.6292	17.8203
Env	738	.1630	97.2076	46.0048	23.8459
Soc	738	3.5958	97.2926	56.8530	20.83749
Gov	738	6.6806	97.6184	52.4051	21.74933
SIZE	738	17.5345	28.3322	22.2111	1.56413
GROWTH	738	-1.00009	6.16605	.05125	.33481
LEVERAGE	738	.000180	136.8802	1.0758	5.1322
Valid N (listwise)	738				

Based on Table 1, the average value of Tobin's Q is lower than the standard deviation. The highest or maximum value is 8.005, which shows that the value of a company is more significant than its assets, and it shows the company's market value. ESG, Env, Sos, and Gov data are homogeneous because the mean values exceed the standard deviation. The highest average ESG in 2019-2021 was 52.63%, which means that the average company in ASEAN has contributed to good sustainable practices. The highest ESG value is 91.03%. The lowest ESG value is 6.47% which is still positive. In addition, the average value of the ESG pillar is the Social score, which is 56.85%.

The regression results of this study are shown in Table 2 as follows:

Table 2. Hypothesis Results

	Model 1		Model 2	
	Coefficient	*Prob*	*Coefficient*	*Prob*
C	12.27632	0.0000	21.22233	0.0000
ESGSCORE	-0.027777	0.0000***		
ENV			-0.008159	0.0207**
SOC			-0.014423	0.0005** *
GOV			-0.005844	0.0349**
GROWTH	0.625959	0.0000***	0.636983	0.0000** *
LEVERAGE	0.000675	0.8885	0.000559	0.9076
SIZE	0.402109	0.0001***	0.393900	0.0001** *
R-squared		0.496085		0.566102
Adj R-squared		0.482687		0.572685
Prob(F-statistic)		0.000000		0.000000

Source: Proceed data by EViews 10

In Model 1, it can be seen that the ESG Score significantly negatively affects Firm value. The lower the ESG Score, the better the company value. The variables of firm growth and size are positively significant to firm value. It means that companies with higher company growth and large size will increase their company value. Model 2 shows consistent results on the environmental, social, and governance scores, which are significantly negative on firm value. It means the higher the environmental, social, and governance scores,

the lower the company value. The study results from model 1 and model 2 stated that the ESG and environmental, social, and governance scores consistently proved to have a significant adverse effect on firm Value. These results are different from those (Li et al., 2018), (Alareeni & Hamdan, 2020), Husada & Handayani (2021), and Velte (2017). Companies that are high performers in terms of ESG can show better financial performance in the long term by increasing transparency and accountability. They are expected to attract more investors, reduce reputational and legal risks, and build better relationships with employees, customers, and the local community. Therefore, companies that take action to increase ESG value can generate more excellent long-term value for all stakeholders.

The results of this study align with the findings of (Buallay, 2019) and (Balasubramanian, 2019). According to Friedman (1962) and (Buallay, 2019), social performance may hurt firm Value because the company's goal is to maximize stakeholder wealth through policies in social practices. Shakil (2019) also asserts that implementing better environmental, social, and performance measures often requires higher costs and could signal negative investor behavior. Many investors may perceive costly activities as a reduction of short-term financial performance. Consequently, investors become less interested in investing, decreasing market demand (Safriani, 2020). One of the main reasons that higher ESG scores may lead to lower company values is that companies have to incur additional costs to meet the higher ESG standards. For example, companies should invest more money in more technologies that are more environmentally friendly, provide safer and healthier facilities and services for employees and surrounding communities, or strengthen corporate governance to ensure greater transparency and accountability. So it can reduce a company's profits in the short term, although it can ultimately help increase long-term sustainability. Thus, better ESG performance will result in lower firm Value. Growth and company size proved to have a significant positive effect on firm value. It means that the higher the sales growth, the larger the company's size will be an excellent signal to increase its value.

5. Conclusion

This research's findings suggest a negative correlation between company value and both the ESG score and the scores for environmental, social, and governance factors. In other words, as the ESG scores increase, the company value tends to decrease. In developing countries, environmental performance is considered to require high environmental costs. This additional burden for the company is considered a burden and will worsen the company's financial condition. The company is not an entity that only operates for its own sake but must also provide benefits to its stakeholders. Adopting ESG issues in company policies is a way to signal and meet stakeholder expectations. It is hoped that there will be implications for investors to use this research in making decisions, primarily related to the use of environmental funds, by considering aspects of sustainability and the control function for the community. This study only uses data from ASEAN countries for three years. The recommendation for further research is to expand the sample area for the research period by analyzing the period before and after the pandemic or the industrial sector. To refine the model, add relevant control variables for country-level effects. Conduct separate tests for countries that dominate the number of companies in ASEAN that have ESG assessments.

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