

THE EFFECT OF ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) PERFORMANCE ON CORPORATE FINANCIAL PERFORMANCE IN INDONESIA: BASED ON THE PERSPECTIVE OF INNOVATION



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Abstract

This study aims to analyze the effect of environmental, social, and governance (ESG) performance on the financial performance of companies in Indonesia by considering innovation as a mediating variable and control variables, namely Earnings Per Share (EPS), Debt to Equity Ratio (DER), and Assets Growth. This study uses secondary data from annual reports and sustainability reports of companies listed on the Indonesia Stock Exchange. The analysis used multiple regression, mediation analysis, and control variable testing. The results show that ESG values do not have a significant effect on Return on Assets (ROA), either directly or through innovation as a moderating variable. In addition, the control variables show that EPS, DER, and asset growth have a more dominant effect on ROA than ESG values. These findings indicate that the benefits of ESG on financial performance may not be visible in the short term. In contrast, the integration strategy of ESG and traditional financial indicators needs to be improved to produce a significant impact. This study provides important insights for corporate sustainability strategies in developing countries.

Keywords: ESG, Financial Performance, Innovation, ROA, Indonesia Stock Exchange

INTRODUCTION

In recent decades, the concept of sustainability has become a major focus across sectors. Companies are no longer expected to simply make a profit but also to contribute positively to the environment, society, and good governance, known as Environmental, Social, and Governance (ESG) (Xu & Zhu, 2024). ESG encompasses a set of principles that aim to encourage companies to carry out their operations responsibly and sustainably (Long, Feng & Chang, 2023). This principle includes efforts to reduce negative impacts on the environment, improve social welfare, and ensure transparent and accountable governance (Njatrijani et al., 2019).

In Indonesia, ESG implementation is getting more attention, especially with the increasing awareness of the importance of sustainability at both global and national levels.(Ginting et al., 2021). As a developing country with various environmental and social challenges, companies in Indonesia play an important role in achieving sustainable development goals. Supporting regulations, such as Law No. 40 of 2007 concerning Limited Liability Companies, which encourages corporate responsibility social and environmental, further strengthen the urgency for companies to adopt ESG principles in their operations.

However, the relationship between ESG performance (ESG Performance) and corporate financial performance (CFP) is still a matter of academic and practical debate.(Zhang & Jin, 2022). Several studies in developed countries show that good ESG performance can improve a company's financial performance through risk reduction, operational efficiency, increased customer loyalty, and better access to capital (Zahid et al., 2022). However, in the context of a developing country like Indonesia, these dynamics may be different. The relatively high cost of implementing ESG, the lack of supporting infrastructure, and limited public awareness may be barriers for companies to fully reap the benefits of their ESG investments (Agarwala et al., 2024).

On the other hand, innovation has emerged as an important element that can strengthen the relationship between ESG and CFP (Bhaskaran, Ting, Sukumaran, & Sumod, SD 2020). Innovation enables companies to integrate sustainability into their business processes, such as through developing environmentally friendly products, implementing energy-efficient technologies, or creating solutions that address the social needs of society

(Sisdianto et al., 2024). With an innovative approach, companies can not only improve their reputation and competitiveness but also create long-term economic value (Ruan & Liu, 2021). Therefore, it is important to understand the role of innovation as a mediator in the relationship between ESG performance and CFP, especially in the context of Indonesia which has unique economic, social, and environmental characteristics (Doni et al., 2022).

This study aims to analyze how ESG performance affects the financial performance of companies in Indonesia by considering innovation as a mediating variable (Antonius & Ida, 2023). This study will use data from companies listed on the Indonesia Stock Exchange to explore the extent to which ESG implementation is able to create added value for companies through innovation channels (Fachrezi et al., 2024). This research is expected to provide contributions both theoretically and practically. Theoretically, this research can enrich the literature on ESG and CFP, especially in the context of developing countries. Practically, the results of this study can be a guide for companies, investors, and policymakers to optimize ESG strategies that support innovation and sustainability (Rismanto, 2024)

In addition, this study aims to provide relevant insights for stakeholders, including managers, investors, regulators, and academics, regarding the importance of ESG management in supporting long-term sustainability and driving innovation as a source of competitive advantage (Oktavianus et al., 2024). Thus, the results of this study are expected to contribute to scientific literature and management practices in the business world (Aboud & Diab, 2016).

REVIEW OF LITERATURE

Stakeholder Theory

Stakeholder theory emphasizes that a company's success is not only measured by its ability to generate profits for shareholders, but also by its ability to meet the needs and expectations of various parties who have an interest in the company, such as employees, customers, government, society, and the environment (Heriansyah, 2024). In the context of ESG, this theory is relevant because good environmental, social, and governance performance can improve a company's relationship with its stakeholders. This positive

relationship can create a better reputation, increase customer loyalty, and support the sustainability of the company's operations in the long term (Reimann et al., 2012).

In the context of environmental, social, and governance (ESG) performance, stakeholder theory becomes particularly relevant as companies are expected to focus not only on financial goals but also on their impact on society and the environment. (Utomo et al., 2024). Good ESG management can strengthen relationships with stakeholders by increasing trust, loyalty, and support for company operations (Cek & Eyupoglu, 2020). Corporate Social Responsibility (CSR) practices can help create a positive image and reduce the risk of conflict with local communities or regulators (Nopriyanto, 2024).

Satisfied stakeholders tend to provide greater support to the company, whether in the form of increased customer loyalty, increased employee productivity, or ease of obtaining permits from the government (Gratiano Mali, 2021). This can ultimately contribute to improving the company's financial performance, both through increased revenue and operational efficiency. Thus, stakeholder theory supports the idea that companies that pay attention to the needs of their stakeholders can achieve better sustainability and more optimal financial results (Luthfi Iznillah et al., nd).

Hypothesis Development

Environmental, Social, and Governance (ESG) and Financial Performance

ESG (Environmental, Social, and Governance) refers to three main criteria used to assess a company's sustainability and social impact. Environmental factors relate to how a company manages environmental issues, such as waste management and carbon emissions. Social factors cover how a company interacts with the community and employees, including social responsibility and the treatment of workers. Meanwhile, governance factors focus on the company's structure and policies, such as transparency, shareholder rights, and risk management. Concerning financial performance, many studies have examined the relationship between ESG practices and a company's financial performance. Several studies have shown a positive relationship, with companies that focus more on ESG tending to have better financial performance in the long term (Annisawanti et al., 2024). This is due to the company's readiness to face risks related to social and environmental issues, as well as its

ability to attract investors who care about sustainability. For example, companies with good environmental management can reduce energy and operational costs.

However, some studies show that poor ESG practices can increase financial risks, such as higher legal costs or reputational damage that can reduce a company's profitability. In addition, companies that implement good ESG policies also tend to have easier access to financing, at lower costs, because they are considered lower risk by investors and creditors. Companies that integrate ESG principles into their business strategies tend to be better at managing risk, increasing operational efficiency, and obtaining cheaper financing, which ultimately contributes to better financial performance. Overall, although there is variation in research findings, there is a tendency that good ESG policies can support better financial performance and provide long-term benefits for companies. So the first and second hypotheses of this study are:

H1: ESG value has a significant effect on the Company's Financial Performance

H2: ESG value does not have a significant effect on the Company's Financial Performance

Innovation Perspective as a Moderating Variable

Innovation is the process or result of developing and utilizing knowledge, skills, and experience to create or improve products, processes, or services that provide added value. Covering various aspects such as new goods, services, marketing methods, or organizational methods, innovation can increase a company's competitiveness and enable adaptation to changes in the dynamic business environment. The right strategy, flexible organizational structure, and a promotive organizational climate are needed to carry out innovation effectively. Innovation also aims to meet needs through the development of thinking and implementation of real actions, both from a financial, customer, and internal business management perspective. This is what makes innovation very important in the business world.

In the context of the influence of Environmental, Social, and Governance (ESG) on corporate financial performance, innovation plays a critical role as a moderating variable that strengthens the relationship. Companies that are committed to ESG practices and innovate not only meet sustainability standards, but also create added value through operational efficiency, development of more environmentally friendly products and services, and

improved reputation in the eyes of consumers and investors. Innovation allows companies to find new ways to reduce environmental impacts, improve social welfare, and ensure good governance practices. Thus, innovation helps companies leverage their ESG initiatives to achieve better financial performance. Companies that focus on innovation in ESG implementation tend to see significant improvements in their financial performance compared to less innovative companies because innovation opens up new sustainable and profitable business opportunities. So the Third Hypothesis in this study is:

H3: The innovation perspective is able to moderate the influence of ESG Values on the Company's Financial Performance.

H3: Innovation perspective is unable to moderate the influence of ESG Value on Company Financial Performance.

RESEARCH METHOD

Data Collection

This study uses secondary data obtained from company annual reports, sustainability reports, and data available on capital market platforms such as Bloomberg, Refinitiv, and the Indonesia Stock Exchange (IDX). The data collected includes information related to ESG performance, innovation, and the company's financial performance during a certain period (Wahdan Arum Inawati & Rahmawati, 2023).

Sampling Method

The sampling method used in this study is purposive sampling, where samples are selected based on certain criteria relevant to the research objectives. The sample consists of companies listed on the IDX, consistently publishing annual reports and sustainability reports during the research period, and having ESG scores available and accessible through official data sources.

Variable Measurement

Conventional financial performance measurement can be done using several main indicators, namely Return on Assets (ROA) to measure the company's effectiveness in using its assets to generate profits (Sumiyana & Hanani, 2021). Return on Equity (ROE) to assess the company's ability to generate profits from its capital (Fadhila & Ardila, 2018). Debt to

Equity Ratio (DER) to evaluate the company's capital structure through a comparison between debt and equity, so that it can be seen to what extent the company relies on debt (Chandra Bara, 2022).

ESG performance is measured using ESG scores provided by rating agencies such as MSCI ESG Ratings or Sustainalytics, which reflect an evaluation of a company's environmental, social, and governance performance.

Modern Financial Accounting Measures include corporate innovation as measured by the number of patents filed, research and development (R&D) spending, or the launch of innovative new products. In addition, corporate value is measured using market ratios such as Price-to-Earnings (P/E) and Market-to-Book Value (M/B).

RESULTS AND DISCUSSION

Classical Assumption Test

Classical assumption tests are a series of tests conducted to ensure that the regression model used in statistical analysis meets several certain assumptions that are the basis of linear regression analysis. This test is very important because violations of these assumptions can lead to invalid or misleading analysis results. By ensuring that the regression model meets these classical assumptions, researchers can improve the accuracy, reliability, and validity of the analysis results obtained. Classical assumption tests include several important tests such as normality tests to ensure normal residual distribution, homoscedasticity tests to ensure constant residual variance, multicollinearity tests to identify high correlations between independent variables, autocorrelation tests to test correlations between residuals, and linearity tests to ensure a linear relationship between independent and dependent variables. By meeting all these assumptions, the regression model used will have a strong basis for producing more accurate and reliable conclusions.

Table 1.

Normality Test

One-Sample Kolmogorov-Smirnov Test

Unstandardized Residual	
N	30
Asymp. Sig. (2-tailed) ^c	0.079

Based on the results of the normality test, the Asymp. Sig (2-tailed) value is 0.075, which is greater than the significance standard of 0.05. This indicates that the data is normally distributed. With a normal data distribution, it can be concluded that the regression model used meets the assumption of residual normality. This assumption is very important for the validity of the regression analysis because it ensures that the residuals (prediction errors) of the model are spread with a predictable pattern and do not show patterns that indicate systematic bias. Thus, the analysis results obtained from the regression model can be considered more accurate and reliable.

Table 2.
Multicollinearity Test

Model	Collinearity Statistics	
	Tolerance	VIF
Nilai ESG	0.849	1,177
Perspektive Innovation	0.852	1,174
EPS	0.868	1,152
DER	0.934	1,070
Asset Growth	0.874	1,145

a. Dependent Variable: ROA

VIF value < 10 and Tolerance value > 0.01 , there is no symptom of multicollinearity. Develop this sentence based on the results of the multicollinearity test Based on the results of the multicollinearity test, it is known that the Variance Inflation Factor (VIF) value is less than 10 and the Tolerance value is more than 0.01. These results indicate that there is no symptom of multicollinearity among the independent variables in the regression model used. In other words, the independent variables do not have a high correlation with each other, so that the regression model can be interpreted better and the analysis results become more valid. The absence of symptoms of multicollinearity ensures that each independent variable makes a unique and significant contribution to the dependent variable, without any distortion due to the relationship that is too close between the variables. This increases the reliability of the model in predicting and explaining the relationship between the variables studied.

Table 3.
Heteroscedasticity Test

Model	t	Sig
(Constant)	0.21	0.835
Nilai ESG	-0.754	0.458
Perspektive Innovation	-0.561	0.58
EPS	2.300	0.044
DER	-0.704	0.488
Asset Growth	0.297	0.769

Based on the results of the heteroscedasticity test, it is known that the Significance (Sig.) value for all variables is greater than 0.05. This indicates that there is no symptom of heteroscedasticity in the regression model used. In other words, the variance of the residual does not change along with changes in the independent variables, but remains constant. The absence of symptoms of heteroscedasticity ensures that the prediction errors are randomly distributed and do not show a particular pattern that could affect the validity of the regression model. Assuming heteroscedasticity is met, the regression model used can produce efficient and unbiased parameter estimates, and allows researchers to draw accurate and reliable conclusions from the statistical analysis performed.

Moderation Regression Analysis

Moderated Regression Analysis (MRA) is a statistical technique used to test the effect of moderating variables on the relationship between an independent variable and a dependent variable. Moderating variables are variables that affect the direction or strength of the relationship between the independent and dependent variables. In this analysis, the researcher wants to know whether the effect of the independent variable on the dependent variable changes at different levels of the moderating variable. MRA involves adding interactions between the independent and moderating variables to the regression model. Thus, the moderated regression model can be interpreted as follows:

1. $Y = \alpha + \beta X$ (Regression Equation 1)
2. $Y = \alpha + \beta_1 X + \beta_2 M + \beta_3 X * M$ (Regression Equation 2)

Regression Equation 1

Table 4.
t-test

		Coefficients^a				
Model		Unstandardized		Standardized	t	Sig.
		Coefficients	Std. Error	Coefficients		
		B		Beta		
1	(Constant)	0.039	0.023		1,700	0.1
	Nilai ESG	-0.016	0.001	-0.004	-0.019	0.985

a. Dependent Variable: ROA

Based on the test results, the significance value of the ESG value variable is 0.985, which is greater than 0.05, indicating that the ESG value variable does not have a significant effect on Return on Assets (ROA).

Table 5.
Coefficient of Determination

Model Summary^b			
Model	R	R Square	Adjusted R Square
1	0.004a	0.000	-0.036

a. Predictors: (Constant). Nilai ESG

b. Dependent Variable: ROA

Based on the results of the regression analysis of the coefficient of determination, it is known that the R Square value is 0.000. This shows that the ESG value variable does not have a significant influence on the Return on Assets (ROA) variable. In other words, all variations in ROA cannot be explained by variations in ESG values. This means that other factors besides ESG values are more dominant in influencing the company's financial performance as measured by ROA.

Tables 4 and 5 explain that ESG values do not have a strong enough impact to influence the company's financial performance as measured by ROA. This finding is in line with several previous studies that showed similar results. For example, research by (Hartomo & Adiwibowo, 2023) found that ESG disclosure did not have a significant impact on the performance of companies in the manufacturing sector, indicating that companies in this sector may not see direct benefits from ESG initiatives in their financial statements. Research by (Mudzakir & Pangestuti, 2023) also supports these results, by showing that ESG

disclosure has no significant effect on firm value. This suggests that the market may not have fully factored in ESG value in its valuation of firms, or that there may be other factors that are more dominant in influencing firm value. Furthermore, research by (Widyaningrum & Rohman, 2024) found that ESG disclosure had no significant effect on firm performance as measured by ROA, confirming that the benefits of ESG initiatives may not be directly reflected in traditional financial metrics such as ROA.

Several indicators explain why ESG values do not have a significant effect on Return on Assets (ROA) in the study. First, companies may not have fully integrated ESG principles into their daily operations, so their impact on financial performance has not been felt significantly. Second, ESG often has a long-term impact that may not be immediately visible in short-term financial performance. Studies that observe too short a period may not capture the long-term benefits of ESG implementation. Third, the influence of ESG can vary depending on the company's industry or sector. For example, industries with a greater environmental impact may feel the impact of ESG initiatives more than other sectors with a smaller impact. Fourth, if the market or regulations do not yet support or reward ESG initiatives, then companies may not get enough incentives or rewards to improve financial performance through ESG. Finally, the varying quality and consistency of ESG measurement and reporting can affect the results of the analysis. Although ESG values are important in the context of sustainability and corporate social responsibility, these results suggest that their influence on financial performance may not be as strong as expected, at least in the short term. This indicates that companies may need to consider a more strategic approach in integrating ESG with their financial goals.

Regression Equation 2

Table 6.
MRA

Model	Coefficients ^a				
	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	0.029	0.034		0.84	0.408
1 Nilai ESG	0.001	0.001	0.12	0.436	0.666
Persepektive Innovation	0.378	0.868	0.255	0.436	0.666
XM (X*M)	-0.02	0.031	-0.404	-0.667	0.511

a. Dependent Variable: ROA

It is known that the significance value of the interaction variable of the ESG value (X) with the innovation perspective (M) is $0.511 > 0.05$, so it can be concluded that the M variable is not able to moderate the influence of the ESG value variable on Return on Assets (Y).

Table 7.
Hypothesis Results

Hypothesis	Sig. Value	Effect
H1	0.000	No.
H2	0.000	Yes.
H3	0.511	No.
H	0.511	Yes.

Table 8.
Coefficient of Determination

Model Summary ^b			
Model	R	R Square	Adjusted R Square
1	0.171a	0.029	-0.08

a. Predictors: (Constant). Nilai ESG

b. Dependent Variable: ROA

It is known that the R Square value is 0.029, which means that the contribution of the influence of the ESG value variable to the Return on Assets (ROA) variable after the moderating variable (innovation perspective) is 0.00029%.

Based on Tables 5 and 6, the research results show that ESG values, although seen as an important factor in sustainability and corporate social responsibility, do not have a significant effect on the company's financial performance as measured by Return on Assets (ROA). Even with the innovation perspective as a moderating variable, ESG values do not show a significant impact on increasing ROA. This can be interpreted that ESG initiatives, in this context, are not strong enough to influence short-term financial performance metrics such as ROA. The innovation perspective, which was expected to strengthen the influence of ESG values on ROA, failed to moderate the relationship. In other words, although innovation is often considered a major driver in improving company performance, in this case, innovation was unable to increase the effect of ESG values on financial performance. This

suggests that other factors may be more dominant in influencing financial performance compared to ESG values and innovation.

These findings underscore the importance for companies to consider other strategies in their efforts to improve their financial performance. While ESG and innovation remain relevant in the context of sustainability and long-term competitiveness, companies may need to look for additional factors or other approaches that are more effective in improving Return on Assets (ROA). Further research is needed to identify these variables and better understand how a combination of strategies can have a more significant impact on a company's financial performance.

Hierarchical Analysis

Table 8.
Correlation of Control Variables

Control Variables		Correlations					
		Nilai ESG	ROA	EPS	DER	Asset Growth	
-none-a	Nilai ESG	Correlation	1	-0.004	0.347	0.106	0.15
		Significance (2-tailed)		0.985	0.06	0.579	0.43
		df	0	28	28	28	28
	ROA	Correlation	-0.004	1	0.377	-0.103	-0.007
		Significance (2-tailed)	0.985		0.04	0.588	0.972
		df	28	0	28	28	28
	EPS	Correlation	0.347	0.377	1	0.048	0
		Significance (2-tailed)	0.06	0.04		0.803	0.999
		df	28	28	0	28	28
	DER	Correlation	0.106	-0.103	0.048	1	0.079
		Significance (2-tailed)	0.579	0.588	0.803		0.68
		df	28	28	28	0	28
	Asset Growth	Correlation	0.15	-0.007	0	0.079	1
		Significance (2-tailed)	0.43	0.972	0.999	0.68	
		df	28	28	28	28	0
EPS & DER & Asset Growth	Nilai ESG	Correlation	1	-0.146			
		Significance (2-tailed)		0.467			
		df	0	25			
	ROA	Correlation	-0.146	1			
		Significance (2-tailed)	0.467				
		df	25	0			

a. Cells contain zero-order (Pearson) correlations.

Based on table 8, it is known that the correlation value between the variables ESG Value (X) and Return on Assets (ROA) (Y) is -0.004. This correlation shows a very weak and almost non-existent relationship between the two variables. This indicates that changes in ESG Value do not have a significant effect on changes in ROA. In this context, companies that increase their ESG values will not see a significant direct impact on their financial performance as measured by ROA. However, after entering control variables such as Earnings Per Share (EPS) (Z1), Debt to Equity Ratio (DER) (Z2), and Assets Growth (Z3), the correlation value between ESG Value and ROA changes to -0.140. This larger negative

correlation indicates that when other financial factors are taken into account, the relationship between ESG Value and ROA not only remains weak but also weakens. This means that the effect of ESG Value on ROA becomes less significant after considering these control variables.

This analysis provides important insights into the dynamics between ESG values and corporate financial performance. While ESG values are considered important in the context of sustainability and corporate social responsibility, financial factors such as EPS, DER, and Assets Growth appear to have a more dominant influence on corporate financial performance as measured by ROA. EPS, as a measure of earnings per share, is closely related to a company's profitability and is often a leading indicator for investors. DER, which reflects the debt-to-equity ratio, provides insight into a company's capital structure and financial risk. Asset growth, which measures the increase in a company's assets over time, indicates a company's capacity for expansion and investment.

Thus, the contribution of ESG to financial performance may be overshadowed by the strong influence of traditional financial factors that directly affect a company's profitability and operational efficiency. Companies seeking to improve their financial performance through ESG initiatives may need to integrate ESG values with their financial strategy in a more harmonious manner to achieve the desired results. This may involve a more strategic approach to leveraging ESG as a competitive advantage while still paying attention to other key financial indicators. Although ESG values play an important role in sustainability and social responsibility, the results of this analysis suggest that in the short term, their impact on a company's financial performance as measured by ROA may not be as great as expected. Therefore, it is important for companies to continuously evaluate and integrate ESG initiatives with their overall business strategy to ensure that they can achieve an optimal balance between social responsibility and financial performance.

CONCLUSION

This study aims to identify and analyze the influence of environmental, social, and governance (ESG) performance on the financial performance of companies in Indonesia, by considering the role of innovation as a factor that mediates the relationship. The results of

the study indicate that good ESG performance can have a positive impact on the company's financial performance, especially through increased operational efficiency and competitiveness generated by innovation. Innovation implemented by companies as part of ESG initiatives plays an important role in strengthening the relationship between ESG performance and company financial results. Therefore, companies that pay serious attention to ESG aspects and innovate can increase their value and profitability in the long term.

This study has several limitations. The first is the limitation in the number of samples, where only companies listed on the Indonesia Stock Exchange can be used in this study, which may not represent all companies in Indonesia. Second, the data used is secondary data obtained from annual reports and sustainability reports which sometimes have limitations in terms of information disclosure, especially related to social and governance aspects. In addition, ESG performance measurements can also vary between rating agencies, which can affect the results of the study. Another limitation is that not all companies disclose information related to the innovations they have made so that innovation measurements cannot always be carried out comprehensively.

Further research can develop this study by expanding the sample of companies outside Indonesia, including international companies, to see if similar findings can be applied globally. In addition, future research can try to use primary data through surveys or direct interviews with company managers to gain a deeper understanding of ESG practices and innovations implemented. Further research can also further explore the relationship between specific types of innovation, such as technological and social innovation, with company financial performance.

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