ESG Performance and Firm Value: An Empirical Study in Indonesia

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Isti Rahayu*
Department of Accounting, Universitas Islam Indonesia

Muhammad Isnanda Nurman Sanjaya
Department of Accounting, Universitas Islam Indonesia

ABSTRACT

Environmental, social, and governance (ESG) is one of the benchmarks when investors make green investment decisions. This research aims to investigate the influence of ESG performance on firm value, with financial performance including profitability and capital structure as the mediating variable. The research sample was companies listed on the ESG Leaders (IDXESGL) index from 2020 to 2022, with a total number of 90 companies. This research used PLS analysis method. The findings of this research showed that ESG performance had a positive influence on profitability, ESG performance had a negative influence on capital structure, and profitability had a positive influence on firm value. However, this research did not manage to prove the influence of ESG performance on firm value and the influence of capital structure on firm value. This research found that profitability could mediate the influence of ESG performance on firm value, but could not prove capital structure as a mediating variable between ESG and firm value. The findings of this research may assist in company management's understanding of the role of ESG and may help them consider implementing ESG as it has an impact on increasing financial performance and market performance.

Keywords: ESG Performance, Firm Value, Profitability, Capital Structure.

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1. INTRODUCTION

As cases of environmental damage are increasing in Indonesia, companies are aiming at increasing reporting on environmental, social, and economic aspects. They adopt the people, planet, and profit (3P), also known as the triple bottom line (TBL), introduced by Elkington (1997). This concept refers to a sustainability idea which aims to achieve balance by improving performance on three dimensions: environmental, social, and governance, known as ESG. An effective implementation of ESG can help companies identify risks, encourage innovation, and boost their reputation. In addition, it can also increase transparency, support long-term sustainability, and enhance financial performance (The Association of Chartered Certified Accountants, 2013). Increased financial performance will definitely attract prospective investors which in turn increase market performance. In relation to firm value, firm value is the management's success in managing company resources. A good firm value highly depends on effective governance and its impacts on the environment and the surrounding communities. Companies that demonstrate social and environmental responsibility tend to be able to build public trust and support, and are able to play an important role in company sustainability (Scholtens, 2008; Syafrullah &

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Muharam, 2017). Companies that apply ESG model could incorporate ESG principles into their company policies. With good ESG performance, companies could gain consumers' and investors' trust which can improve financial performance and firm value (Hasnawati, 2005; Suryandari *et al*., 2021).

Nevertheless, many companies frequently focus more on achieving financial profit and ignore the negative impact on the environment and society (Cai *et al*., 2015), such as PT XLI's illegal metal smelting activities (Kementerian Lingkungan Hidup dan Kehutanan, 2023) which show non-compliance with environmental and social responsibilities. Therefore, with the Financial Authority Services Act (OJK) Number 51/POJK.03/2017, the Indonesian government encourages a sustainable reporting program to ensure companies take into account the environmental, social, and economic aspects through the implementation of effective ESG. In the meantime, to facilitate investors to select company stocks that contribute to sustainability, Indonesia Stock Exchange issued a new index called IDX ESG Leaders (ESGL) on 8 December 2020. This index analyzes the stock price performance of companies with good ESG ratings and are not involved in controversies. The creation of this index shows the IDX's commitment to supporting long-term investment in Indonesia.

Previous studies on the relationship between ESG performance and firm value have shown mixed results. Buallay (2018), S. Chen *et al*. (2023), Z. Chen and Xie (2022), Naeem *et al*. (2022), Yoo and Managi (2022), and Zhou *et al*. (2022) found that ESG performance enhanced firm value. In contrast, Husada and Handayani (2021), and Juliandara *et al*. (2021) showed that ESG disclosure did not have a significant influence on firm value. The latter finding is in line with Junius *et al*. (2020) who found that ESG performance did not have a significant effect on firm value. Liang et.al. (2023) stated that a company with high ESG ratings does not mean its stock liquidity risk is low, and different industries have different impacts of ESG on stock liquidity risk. Syahfi (2023) found a strong positive influence on investor's financial literacy with their sustainability information and the usage of negative screening strategy toward their sustainability investment decision.

Since ESG is an important indicator that investors should consider before investing, this research built on the study of Zhou *et al*. (2022) which examined the influence of ESG on firm value using profitability (ROA) as the mediating variable. Capital structure (DER) was added in this research as the mediating variable to measure the company's ability to fulfill its long-term financial obligations. This research will be beneficial to companies and investors as it provides information on the influence of ESG performance on financial and market performances.

2. THEORETICAL REVIEW

2.1 Stakeholder and Signaling Theories

This research used the stakeholder theory that emphasizes the importance of engaging with many parties involved in a company's operations, including the stakeholders (Donaldson & Preston, 1995). A company is expected to meet the wishes and needs of its stakeholders through transparency of financial and non-financial information (Gray *et al*., 1995), which enables the stakeholders to support the company. The support and attention from the stakeholders can positively contribute to the company's performance through an increase in investment, capital involvement, or product use, which can potentially boost the company profitability and strengthens the relationship between the company and the stakeholders.

This research also used the signaling theory which states that signals generated by a company have a significant influence on investors' perceptions and other external parties

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in making investment decisions (Gumanti, 2009). The disclosure of non-financial information, including ESG is deemed to be positive for stakeholders. When a company transparently discloses information on environmental, social, and governance issues, it can lead to positive appraisal from investors, thus boosting the company's stock price, and ultimately the company value.

2.2 The Index of Indonesian Stock Exchange ESGL Concept

In 2020, the Indonesia Stock Exchange introduced a thematic index ESG Leaders Index (IDXESGL) to provide investors with a description of corporations with effective ESG practices. This index evaluates ESG performance using risk metrics and classifies companies into certain categories based on ESG score assessment. The analysis is conducted by Morningstar Sustainalytics by considering two dimensions of ESG issues: exposure and risk management of ESG (Bursa Efek Indonesia, 2022). The companies identified are then grouped into one of the following five categories:

Table 1. Score Categories of ESG Risks

Risk Score	Category	Description
0-10	Negligible	considered to have negligible ESG risk
10-20	Low	considered to have lower ESG risk
20-30	Medium	considered to have medium ESG risk
30-40	High	considered to have higher ESG risk
>40	Severe	considered to have severe ESG risk

2.3 Research Hypotheses

According to stakeholder theory, companies that actively disclose sustainability information to their stakeholders show long-term commitment to society (Behl *et al*., 2022). Research findings of Buallay (2018), Z. Chen and Xie (2022), and Zhou *et al*. (2022) show that there is a positive correlation between ESG and firm value. Companies with good ESG scores tend to have a higher firm value than those with lower ESG performance. Implementing ESG principles is critical to investor decision-making as it reduces company risks and shows a commitment to sustainability. Based on the evidence gathered, this research proposes the following hypothesis:

H1: ESG performance has a positive influence on firm value.

Stakeholder theory asserts that a company has a social responsibility to its stakeholders. Therefore, a company should consider the environmental, social, and governance (ESG) criteria in making business decisions. Research of Z. Chen and Xie (2022), Husada and Handayani (2021), Priandhana (2022), Setiani (2023), and Yoo and Managi (2022) found a positive relationship between ESG performance and company profitability. Focus on environmental issues can reduce operational costs and increase efficiency. More concern over environmental and social aspects also attracts consumers who care about sustainability, which in turn boosts sales. In addition, good governance can help manage risks and decrease legal costs. The implementation of ESG in a company can spur innovations and differentiation, paving the way to higher profitability (Setiani, 2023). Therefore, the following hypothesis is proposed:

H2: ESG performance has a positive influence on company profitability.

Signaling theory states that a company can use ESG practices to deliver positive messages to investors and creditors. ESG practices in a company demonstrate the company's commitment to sustainable and accountable business practices. Research

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findings of Adeneye *et al*. (2023), Suzandry and Hermawan (2023), and Zahid *et al*. (2023) showed a significant and negative correlation between ESG performance and capital structure. Companies with good ESG tend to have more efficient and sustainable operational practices, thus enhancing profitability without depending on high debts. In addition, they usually gain greater support from investors and stakeholders and obtain better access to financial resources without relying on debts. Based on this, this research puts forward the following hypothesis:

H3: ESG performance has a negative influence on capital structure.

Profitability is an indicator of financial performance, which shows a company's ability to generate profits. Recent studies by Dzulhijar *et al*. (2021), Purba and Mahendra (2022), Rossa *et al*. (2023), and Zhou *et al*. (2022) reveal that profitability has a positive influence on firm value. A higher level of profitability can attract investors as it indicates higher return potential. According to signaling theory, higher profitability is deemed a positive signal to investors, encouraging them to invest and hence improving firm value. Based on this analysis, hypothesis H4 is proposed as follows:

H4: Profitability has a positive influence on firm value.

Capital structure is a crucial issue in company management as it can affect financial stability. Previous studies of Dzulhijar *et al*. (2021), Purba and Mahendra (2022), and Rossa *et al*. (2023) showed a negative correlation between capital structure and firm value. Excessive use of debts or too high capital structure may have a negative impact on firm value, particularly when the management is unable to manage debts well or when the interest charge is high. Large interest charges may bring in concern about long-term financial stability and cause reduced investment attractiveness. Thus, the following hypothesis is proposed:

H5: Capital structure has a negative influence on firm value.

2.4 Research Framework

The conceptual model in this research is presented in Figure 1.

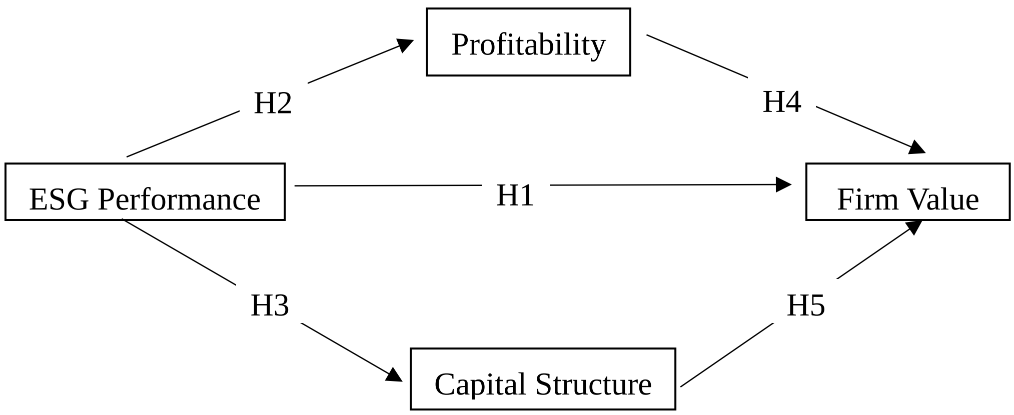

Figure 1. Conceptual Framework of the Research

3. RESEARCH METHOD

3.1 Research Sample

The research population was companies listed on ESG Leaders Index created by the IDX. The sampling method used was purposive sampling with the following criteria:

- The sample consisted of the companies listed on IDXESGL from 2020 to 2022.

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- The selected companies had complete financial data available for the relevant period of 2020 – 2022.

3.2 Research Variables

This research had one dependent variable, which was firm value, one independent variable, which was ESG performance, and financial performance as mediating variables measured with profitability and capital structure.

Firm value indicates investors' assessment of a firm's success. In this research, firm value was measured using Tobin's Q, which compares the market value of a company to the replacement cost of all its assets. If the Tobin's Q value of a company is <1, the replacement cost of the company's assets exceeds its market value. The assessment of market value in this research was based on share prices on market close on the day the annual financial report was published. The calculation of Tobin's Q referred to the study by Zhou *et al*. (2022), which is as follows:

$$Tobin's\ Q = \frac{Total\ Market\ Value + Total\ Book\ Value\ of\ Liabilities}{Total\ Book\ Value\ of\ Assets}$$

ESG performance demonstrates a company's success in implementing ESG in its operations. ESG performance in this research used the value of ESG risk available in the IDXESGL index. ESG index indicates the degree of risks to the company's economic value caused by the performance in environmental, social, and governance aspects (Standard Chartered, 2022). A higher level of ESG risk indicates lower ESG performance, while lower ESG risk shows higher ESG performance (Priandhana, 2022). Thus, ESG risk is an inverse measure of environmental, social, and governance performance. ESG performance variables are measured by evaluating ESG scores which are grouped into five categories using an ordinal scale.

Table 2. Category of ESG

Score of Risks	Classification	Category (Ordinal Scale)
0-10	Negligible	5
10-20	Low	4
20-30	Medium	3
30-40	High	2
>40	Severe	1

Profitability is a metric used to measure the degree to which a company or business entity is able to generate profits through its operational activities. It is one of the most significant financial ratios in analyzing a company's financial performance. Profitability provides views of a company's efficiency and capability to generate profits from available resources. Profitability is measured by using the ratio of return on assets (ROA).

$$ROA = \frac{Net\ Profit}{Total\ Asset} \times 100\%$$

Capital structure is measured by comparing a company's total debt with the total equity. Comparing these two elements is important to determine risk and return levels that

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a company can expect. To put it another way, a properly and optimally managed capital structure is more likely to create the right balance between debt and equity financing. The risk level in capital structure is determined by the extent to which a company relies on debts to fund its operations; a higher debt ratio can increase financial risk due to the interest burden that has to be paid. Capital structure is measured using the following debt-to-equity (D/E) ratio:

$$DER = \frac{Total\ Liabilities}{Total\ Equity} \times 100\%$$

3.3 Data Analysis Method

This research used descriptive statistics to analyze the data. The hypothesis testing was conducted using quantitative analysis with partial least squares (PLS) method. The analysis technique employed structural equation modelling (SEM)-PLS carried out in three stages: outer model, inner model, and test of specific indirect effect.

4. RESULTS AND DISCUSSION

4.1 Description of the Research Sample

A descriptive statistical test was used to explain the minimum, maximum, average, and standard deviation scores of ESG performance, firm value, and mediation (profitability, and capital structure). The results are presented in Table 3.

Table 3. Results of Descriptive Statistical Test

Variable	Minimum	Maximum	Average	Standard deviation
ESG risk	3	4	3.29	0.46
Tobin's q	0.42	14.32	1.89	2.03
ROA	-0.03	0.35	0.07	0.07
DER	0.11	16.08	2.26	2.81
N = 90				

ESG performance refers to the extent to which a company can incorporate environmental, social, and governance aspects in its business operations. The variable of ESG had the lowest score of 3, indicating a company's operations with low environmental and social impact and negligible risks. The highest score was 4, indicating a company's operations with moderate environmental and social impact and minimal risks. The average value of ESG performance was 3.29, which indicates that each company in the research sample had strong management system and measures taken to mitigate risks.

The lowest Tobin's q value was 0.42, which suggests that the stock market value of a company was 0.42 times its book value. This indicates that the stock market value was smaller than its book value as the value of Tobin's q was below 1. The highest value of Tobin's q was 14.32, which indicates that the stock market value of a company was 14.32 times its book value. This means that the stock market value was greater than its book value as the value of Tobin's q was above 1. On average each company in the research sample had a firm value (Tobin's q) of 1.89, which suggests that the stock market value of a company was 1.89 times its book value. This indicates that the stock market value was smaller than its book value as the value of Tobin's q was above 1, with a deviation of 2.03.

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The lowest profitability value (ROA) was -0.03, which indicates the company experienced a net loss of IDR 0.03 of the use of IDR 1 from the company asset. The highest profitability (ROA) was 0.35, which indicates the company generated a net profit of IDR 0.35 of the use of IDR 1 from the company asset. Each company in the research sample on average had a profitability value (ROA) of 0.07, indicating that each company could generate a net profit of IDR 0.07 of the use of IDR 1 from the company asset, with a deviation of 0.07.

The lowest value of capital structure was 0.11, which shows that the company had 0.11 times its debt over its equity. The highest value of capital structure (DER) was 16.08, which indicates that the company had 16.08 times more debt than equity. On average, each company in the research sample had a capital structure value (DER) of 2.26. This indicates that each company had 2.26 times more debt than equity, with a deviation of 2.81.

4.2 Results of Outer Model Testing

The results of convergent validity, discriminant validity, and composite reliability measurements are presented in Table 4 and Table 5.

Table 4. Values of Convergent Validity

Variable	Factor Loading	Explanation
ESG Performance	1.000	Valid
Firm Value	1.000	Valid
Profitability	1.000	Valid
Capital Structure	1.000	Valid

Table 4 shows that the value of factor loading of the entire manifestation variables indicates that the indicators in the research variables met the criteria of convergent validity, and no indicator needed to be excluded from the analysis. This finding indicates that the construct measured by such indicators could be deemed valid and reliable for further analysis.

Table 5. Values of Cross-Loading

	ESG Performance	Firm Value	Profitability	Capital Structure
ESG Performance	1.000			
Firm Value	0.282	1.000		
Profitability	0.410	0.800	1.000	
Capital Structure	-0.212	0.001	-0.159	1.000

Table 5 shows that all values of cross-loading on each item exceeded 0.70, which indicates that the manifestation variable in this research was adequate to explain the latent variable. This suggests that the whole items had strong validity or strong discriminant validity.

Table 6 shows that all variables examined in reliability testing using Cronbach's Alpha and Composite Reliability had values that exceeded the threshold of 0.70. In addition, the validity testing results using average variance extracted (AVE) also showed that these values exceeded the 0.50 cutoff. Thus, the analyzed variables were proven to have adequate reliability and validity.

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Table 6. Values of Composite Reliability

	Cronbach's Alpha	Composite Reliability	AVE
ESG Performance	1.000	1.000	1.000
Firm Value	1.000	1.000	1.000
Profitability	1.000	1.000	1.000
Capital Structure	1.000	1.000	1.000

4.3 Results of Inner Model Analysis

The results of structural model measurement consisting of Adjusted R-squared, predictive relevance, and the results of model fit test are presented in Tables 7, 8, and 9.

Table 7. Value R^2 of Endogenous Variables

	R-Square	Adjusted R Square
Firm Value	0.659	0.647
Profitability	0.168	0.158
Capital Structure	0.045	0.034

Table 7 shows a relationship between ESG performance and firm value with a coefficient of 0.647. This finding suggests that 64.7% of the variation in the variable of firm value could be explained by the variation in the variable of ESG performance. On the other hand, the rest, or 35.3% of the variation in the firm value variable, was expected to be affected by other factors excluded in the analysis.

We also found a correlation between ESG performance and profitability with a coefficient of 0.158. This result shows that 15.8% of the variation in the profitability variable could be attributed to the variation in the variable of ESG performance. The rest, around 84.2% was expected to be influenced by other factors excluded in the analysis.

ESG performance had an influence on capital structure with an estimated coefficient of 0.034. This finding indicates that 0.34% of the variation in the variable of capital structure could be attributed to the variation in the variable of ESG performance. Meanwhile, most of the variation, which was 99.66%, was expected to be affected by other factors excluded in the analysis. Therefore, the influence of ESG performance on capital structure was deemed relatively small.

The assessment of predictive relevance or Q-square indicates the extent to which a model can predict the results accurately based on the existing observational data. The results of the analysis showed that the value of Q-square was greater than 0, which confirmed the reliability of the model in the context of predictive relevance. The test results can be seen in Table 8.

Table 8. Results of Predictive Relevance (Q-Square)

	Q2 predict
Firm Value	0.618
Profitability	0.164
Capital Structure	0.034

The results of the model fit test are presented in Table 9, which shows that the research model met the fit criteria.

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Table 9. Test of Model Fit

Fit Summary	Estimate	Explanation
SRMR	0.030	Good
NFI	0.994	Good

The results of the model testing as shown in Table 9 show that the structural equation modeling (SEM) used yielded a standardized root mean square residual (SRMR) value of 0.030, which was much smaller than the threshold of 0.10 commonly used in research. In addition, a normed fit index (NFI) value of 0.994 showed a nearly perfect model fit, approaching the optimal value of 1. Therefore, the research model as a whole met the fit criteria and was in accordance with the observed data.

4.4 Results of Hypotheses Testing

The results of hypotheses testing are presented in Table 10.

Table 10. Hypotheses Testing

	Indicator	Original Sample	P-Values	Explanation
H1	ESG performance has a positive influence on firm value.	-0.033	0.680	unproven
H2	ESG performance has a positive influence on profitability.	0.410	0.000	proven
H3	ESG performance has a negative influence on capital structure.	-0.212	0.000	proven
H4	Profitability has a positive influence on firm value.	0.834	0.000	proven
H5	Capital structure has a negative influence on firm value.	0.127	0.043	unproven

From the data presented in Table 10, the sample coefficient of the first hypothesis, which is the influence of ESG performance on firm value, was -0.033. Its p-value of 0.680 was much higher than the defined significance level of 0.05. Thus, hypothesis 1 was **not supported**. A possible explanation for this finding might be because the ESG implementation in Indonesia was in a progressive stage, and the country had not managed to apply the sustainability concept or to disclose such information to the public. As a result, investors were unfamiliar with the benefits of ESG. Since ESG performance was not yet mandatory for all companies, investors preferred to use financial performance rather than ESG performance as a basis for investment considerations. Nevertheless, there will be a change in this regard over time as the public becomes more familiar with ESG. This result is in line with the research conducted by Junius *et al*. (2020) which found that ESG performance did not have an influence on firm value.

As shown in Table 10, the sample coefficient of the second hypothesis, that the influence of ESG performance on profitability has a positive direction, indicated that the higher the ESG performance, the higher the profitability. The opposite was also true; the lower the ESG performance, the lower the profitability. The p-value of 0.000 seemed to be much lower than the defined significance level of 0.05. Thus, hypothesis 2 **was supported**. This finding is in line with that of the research of Yoo and Managi (2022), which showed that strong ESG performance had the potential to have a positive and significant effect on profitability. Companies that implement sustainable business practices can reduce waste through energy efficiency, better waste management, and more efficient use of resources.

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In addition, comprehensive ESG strategies can boost the brand image and trust of customers, investors, and other stakeholders. By demonstrating a commitment to social and environmental issues, a company can build stronger relationships with customers and society, which in turn can increase customer loyalty and promote long-term sales growth.

The sample coefficient of hypothesis 3, that the influence of ESG performance on capital structure has a negative direction, indicated that the higher the ESG performance, the lower the capital structure (Table 10). On the contrary, the lower the ESG performance, the higher the capital structure. The p-value of 0.000 was much lower than the defined significance level of 0.05. Thus, the empirical evidence **supported** hypothesis 3. This research finding is in line with that of the study of Suzandry and Hermawan (2023), which showed that companies with good ESG performance tended to have more efficient and sustainable operational practices, resulting in increased profitability and ability to meet their operational needs without depending on high debts. Companies that are concerned with environmental, social, and governance (ESG) issues frequently receive significant support from investors and stakeholders, which means better access to financial resources and is not dependent on debts.

As shown in Table 10, the sample coefficient of hypothesis 4, that the influence of profitability on firm value has a positive direction, revealed that the higher the profitability, the higher the firm value. In contrast, the lower the profitability, the lower the firm value. The p-value of 0.000 was much lower than the defined significance level of 0.05. Thus, hypothesis 4 **was supported**. This result corroborates the result of research of Rossa *et al*. (2023) and Zhou *et al*. (2022), which revealed that an increase in firm value occurred when profitability rose. A company with higher profitability and stable profits can attract investors because a higher profitability ratio reflects higher investment returns. In return, the company's stock price will rise, and its firm value will also increase.

For hypothesis 5, the influence of capital structure on firm value, the sample coefficient as shown in Table 10 was in a positive direction, meaning that the higher the capital structure, the higher the firm value. In contrast, the lower the capital structure, the lower the firm value. The p-value of 0.043 seemed to be lower than the defined significance level of 0.05. Thus, hypothesis 5 was **not supported**. This finding is in line with the study of Ayuningrum (2018), which found that debts could provide significant financial profits to firms for several reasons. Firstly, debts allow companies to use financial leverage to generate profits higher than the interest they pay. Secondly, the capital structure which includes debts allows a company to allocate more of its equity capital to a lucrative investment, which in turn promotes the company's growth. In addition, with interest payment deductible from taxable income, a company may reduce their tax burden, which ultimately increases net profits and firm value.

4.5 Results of Indirect Effect Test

To prove that profitability and capital structure are the mediating variables between ESG and firm value, the Specific indirect Effect test was conducted, and the results are shown in Table 11.

Table 11. Test of Indirect Effect

Indicator	Original Sample	P-Values
ESG performance has a positive influence on firm value through profitability.	0.342	0.000
ESG performance has a positive influence on firm value through capital structure	-0.027	0.092

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As shown in Table 11, ESG performance had a positive and significant influence on firm value through profitability, with a beta coefficient test value of 0.342 or 34.2%. This result was confirmed by the p-value of 0.000, which was much lower than 0.05. Thus, profitability could mediate the influence of ESG performance on firm value.

Nevertheless, the empirical evidence did not support the significant influence of ESG performance on firm value through capital structure, with a beta coefficient test value of -0.027 or -2.7%. The p-value of 0.092 was found to be greater than the significance level of 0.05.

5. CONCLUSIONS

The research findings revealed that ESG performance had a positive and significant influence on profitability, ESG performance had a negative and significant influence on capital structure, and profitability had a positive and significant influence on firm value. However, this research did not manage to prove the influence of ESG performance on firm value and the negative influence of capital structure on firm value.

This research has some limitations. Firstly, it investigated companies listed on the IDXESGL index with a research period of 2020 – 2022. Thus, our findings cannot be generalized to all firms with ESG ratings. Secondly, firm value was measured based on stock prices after the financial reports were released. However, in practice, the IDXESGL index was often published before the publication of financial reports. It gave rise to investors' reactions when the index was published although the financial reports were unavailable. Therefore, further studies are recommended to use a wider range of research object by extending the research period, thus obtaining a larger research sample. In addition, sample stocks to be investigated should not be limited to those listed on the IDXESGL index, but also all firms listed on Indonesia Stock Exchange that have ESG ratings.

Based on the research findings, investors need to take ESG performance into account as it has been proven to affect a company's profitability which in turn impacts firm value. By considering ESG performance, they can anticipate environmental, social, and governance risks, and gain long-term benefits, such as income stability and good reputation. Overall, recognizing the importance of ESG performance as a basis for making investment decisions could lead to more sustainable and responsible investment practices, which ultimately leads to the creation of long-term value for all stakeholders.

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