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Research Article

The Effect of ESG and Green Innovation on the Financial Performance of Listed Firms

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Abstract
This study examines the impact of Environmental, Social, and Governance (ESG) practices and green innovation on corporate financial performance, measured by Tobin's Q. With sustainability gaining prominence globally and in Indonesia evident in the rise of the ESG Leaders Index, there remains limited empirical evidence on its financial implications in the Indonesian context. Using purposive sampling, 19 companies in the ESG Leaders Index were analyzed from 2020 to 2022. Results show that ESG practices had a negative but insignificant effect on financial performance, whereas green innovation had a positive and significant impact. Additionally, firm size and leverage were found to influence performance significantly. These findings highlight that while ESG implementation in Indonesia faces obstacles such as high costs and limited integration, green innovation presents a more immediate pathway to financial improvement. For managers, prioritizing environmentally friendly innovation can boost efficiency, reduce costs, and attract sustainability-minded stakeholders. Meanwhile, ESG practices should be approached with a strategic, long-term mindset to realize their potential value. Sustainability should be embraced not merely as compliance but as a forward-looking investment contributing to long-term profitability.

Keywords: Environmental Social Governance (ESG), green innovation, corporate financial performance, corporate size, leverage.

JEL Classification: G30, Q56, O32

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1. Introduction

As development progresses, the issues faced are also increasingly varied, one of which is sustainability. Sustainability refers to efforts to achieve sustainable economic growth while addressing climate change, natural resource scarcity, and other environmental challenges (Tolliver et al., 2020). Sustainability ensures that business operations should not negatively impact the surrounding population and natural areas and contribute positively to achieving sustainable development goals.

The current era of globalization has brought changes to the firm. Many companies are now required to pay more attention to the impact of their firm activities on the environment and provide positive contributions to society. This result is because people are increasingly aware of the importance of the environment and social welfare (Husada & Handayani, 2021). One form of sustainability implementation in the firm is implementing ESG and green innovation. The application of ESG (Environmental, Social, and Governance) and green innovation is part of the broader application of CSR (Corporate Social Responsibility) (Chouaibi et al., 2019). CSR (Corporate Social Responsibility) is a concept that encourages companies to carry out their responsibilities towards the environment and society (Effendi, 2019).

In its application, ESG and green innovation include various things such as waste management, carbon emission reduction, environmentally friendly product innovation, fair employment policies, labor empowerment, and transparency, as outlined in the firm's sustainability report (Chouaibi et al., 2019). The practical implementation of ESG and green innovation will improve firm performance, increase a good reputation in the long run, create a competitive advantage by creating environmentally friendly products, and reduce risks due to compliance with strict ESG regulatory standards and environmental regulations. They can attract investors who are increasingly concerned about sustainability practices in the firm (Zheng et al., 2023). All of these factors can increase corporate profitability and support long-term growth. Companies can position themselves for long-term success in an increasingly sustainable economy by paying attention to sustainability.

In Indonesia, the application of ESG and green innovation continues to develop. The increasing trend of sustainability investment has shown significant growth in recent years because investors pay more attention to the firm's sustainable practices and operational and financial benefits (Shakil, 2021). However, there are still obstacles in the implementation of ESG and green innovation in Indonesia, especially related to companies' low understanding of sustainability, which require significant initial investments in infrastructure, technology, and corporate policies that come at the expense of companies' financial returns and lack of good framework conditions (Husada & Handayani, 2021). Another obstacle is that certain parties efficiently use this interest to obtain investors' funds. This practice can be categorized as data manipulation and greenwashing. This fraud will affect public trust in the firm's efforts to implement honest practices on sustainable principles (Chandra et al., 2022).

Research by Chouaibi et al. (2019) on financial companies in Germany and the United Kingdom found that applying ESG can positively affect financial performance. Then, Kim & Li (2020) research obtained ESG scores that positively influence a firm's financial performance. In contrast, the research findings conducted by Husada & Handayani (2021) on financial sector companies listed on the Indonesia Stock Exchange show that ESG scores do not influence the firm's financial performance. The same thing was also conveyed by Baran et al. (2022), who examined companies in the energy sector in Poland and stated that the application of ESG does not influence financial performance. Research by Aastvedt et al. (2021) on oil and gas companies in the United States and Europe shows that applying green innovation positively influences the firm's financial performance. This finding was also conveyed by Dai & Xia (2022), who stated that applying green innovation positively influences the firm value of companies listed on the stock exchange in China. Maulana and Mulyadi (2022) state that applying green innovation does not affect firm value in manufacturing companies listed on the Indonesia Stock Exchange from 2014 to 2019. The same thing was also conveyed by Xie et al. (2022), who found that applying green innovation has no effect on firm value in companies in the heavy pollution industry in China. Sustainability issues are more widely researched in several corporate sectors in European and American countries and Asia, especially in China; however, it is still quite limited for Indonesia, which may lead to differences in research results.

This study seeks empirical evidence on how environmental, social, and governance (ESG) performance and green innovation impact a firm's financial performance. This research is expected to benefit companies by helping them implement sustainability and manage finances

properly. The results can also provide helpful information for investors in choosing the right investment. In addition, this research can also be a reference material for future researchers who want to develop research in the same field.

However, until now, there have been inconsistent findings regarding the relationship between ESG and green innovation on corporate financial performance, especially in emerging markets such as Indonesia. Some studies show a positive effect, while others show negative or insignificant results. This inconsistency reflects a research gap that needs to be further explored. In addition, the lack of research that combines ESG and green innovation simultaneously in testing their effects on corporate financial performance in the ESG Leaders Indonesia index makes this study have a novel value. This study contributes to enriching the literature by presenting an empirical approach based on the local Indonesian context and using Tobin's Q indicator as a measure of market performance that is rarely used in similar studies in Indonesia. Thus, this study not only offers a new understanding of the dynamics of ESG and green innovation but also provides a basis for managerial and investor decision-making in the era of sustainability.

2. Literature Review and Hypothesis

Growth of the Firm Theory

The growth of the firm theory was first introduced, who argued that the growth of the firm theory refers to the processes and strategies a firm uses to expand its operations, market presence, and overall size. The theory emphasizes a focus on a firm's internal capabilities and resources as the main drivers of its growth, and there is no necessary reason why a firm should limit its growth prospects and productive opportunities to existing markets (Islamiyati & Faruqi, 2023). The theory explains why some firms succeed in growth and what factors enable some firms to succeed.

Resource-Based View Theory

Wernerfelt (1984) introduced the RBV theory, which describes the collection of resources and capabilities owned by the firm. The resources and capabilities owned by the firm are considered the main components that provide control over sustainable competitive advantage (Bhandari et al., 2021). RBV theory is a strategic management approach that emphasizes the importance of a firm's internal resources to create competitive advantage and growth in the long term, which, of course, will impact the firm's financial performance (Dasuki, 2021). This theory focuses on identifying, developing, and utilizing valuable resources and how these can be utilized (Dasuki, 2021).

Firm Financial Performance

Firm Financial performance refers to evaluating and analyzing how well a firm or stock manages its assets, debt, and capital to achieve desired financial goals (Anhar, 2017). This financial performance measures how efficient and effective the firm is in generating profits, managing assets, and paying debts. Financial performance measurement involves analyzing and evaluating financial statements, financial position, and future performance through financial ratios that utilize data from balance sheets and income statements (Albart et al., 2020)(Husada & Handayani, 2021). In this study, the firm's financial performance is measured by Tobin's Q, which measures the difference between the book value of assets and the firm's market value (Mardiana & As'ari, 2023)(Chouaibi et al., 2019). A high Tobin's Q value indicates that the market values of the firm are positive, indicating that the market value of its shares exceeds the total replacement cost of its physical assets (Ishaq et al., 2021).

Environmental, Social, Governance (ESG)

ESG refers to environmental, social, and corporate governance factors used to evaluate a firm's social and environmental responsibility performance and good corporate governance. ESG is an increasingly important factor in investment decision-making and can affect a firm's financial performance (Firmansyah & Mais, 2024)(Kim & Li, 2021). Environmental, social, and governance (ESG) aspects form the basis for implementing corporate social responsibility and sustainable business. ESG implementation is considered an interrelated activity and forms a whole, indicating that environmental, social, and governance efforts can contribute to achieving corporate sustainability goals (Saleh et al., 2023)(Baier et al., 2020).

Green Innovation (GI)

According to Dai & Xue (2022), green innovation refers to developing and applying new products, processes, technologies, and business models that are environmentally friendly and sustainable. It involves creating innovative solutions that reduce negative impacts on the environment, conserve natural resources, and promote sustainable development. In addition, green innovation aims to improve products, increase productivity and cost efficiency, open new opportunities, and create competitive advantages for companies (Agustia et al., 2019). The application of green innovation encourages businesses to turn waste into purchasable goods, reducing production costs and generating additional profits for them (Afriyanti & Murwaningsari, 2022).

Leverage

Leverage refers to using funding sources in a firm that helps companies obtain funding from debt loans. The purpose of applying leverage is to increase potential profits for shareholders by using loans and fixed expenses to expand the firm's investment and operations (Dina & Wahyuningtyas, 2022). A high level of leverage can increase the firm's profit potential and financial risk because the firm is obliged to pay interest and debt principal. On the other hand, a low level of leverage can reduce financial risk and limit the firm's profit potential. This study uses leverage as a control variable that controls the firm's financial performance as measured by the firm's total liabilities divided by the firm's total equity (Panjaitan & Supriyati, 2023).

Hypothesis

Environmental, social, governance (ESG), and firm financial performance

ESG refers to environmental, social, and corporate governance factors used to evaluate a firm's social and environmental responsibility performance and good corporate governance (Kim & Li, 2021). Firms will benefit from effective ESG implementation if exemplary ESG implementation can be carried out to improve the firm's financial performance. When companies consider environmental, social, and governance factors in strategic decision-making, they manage risks better, reduce long-term operating costs, and improve reputation, which can raise the firm's overall value and increase profitability (Ruan & Liu, 2021). Firms implementing ESG practices are also likely to attract investors who consider non-financial factors in their investment decisions (Zheng et al., 2022). This research is supported by Chouaibi et al. (2019), which state that implementing ESG in the firm positively affects the firm's financial performance. Based on this description, the proposed hypothesis is:

H1: Environmental and social governance (ESG) positively affects the firm's financial performance.

Green innovation and corporate financial performance

Green innovation is a new or modified process, technique, system, or product to avoid or reduce environmental damage (Cahyaningtyas et al., 2022). In its application, green innovation focuses on the efficient use of raw materials and energy, creating opportunities for market expansion and utilizing existing product advantages in a firm, which will impact the firm's financial performance (Dai & Xia, 2022). The application of green innovation also functions not only as a tool to increase market share but also as a planned, proactive, and effective strategy that can assist Companies achieve and maintain firm value sustainably (Agustia et al., 2019). Adopting green innovation can also increase investor and stakeholder confidence in the firm. Firms that engage in environmentally friendly and sustainable business practices tend to attract investors who consider sustainability factors in their investment decisions (Aastvedt et al., 2021). This study is supported by research by Zhang et al. (2020), which states that the application of green innovation in the firm has a positive effect on the firm's financial performance. Based on this description, the proposed hypothesis is

H2: Green innovation positively affects the firm's financial performance.

3. Data and Method

Sample Procedure

The research design in this study uses associative causality to see the causal relationship between variable X and variable Y, with the type of quantitative data from secondary data sources, namely, annual financial reports and sustainability reports obtained through the official website of each firm. The population used in this study are companies contained in the ESG Leaders index on the Indonesia Stock Exchange from 2020 to 2022. The sampling technique used in selecting samples in this study was purposive sampling, with criteria set by the researcher. The total sample companies amounted to 19 companies.

Measurement

Environmental, Social, Governance (ESG)

This study uses ESG scores, which are used to measure ESG performance and show how well the firm can implement environmental, social, and governance elements in the business it runs (Kim & Li, 2021). The score is obtained from the indicators that the researcher has determined. Each indicator is given 1 point if the firm qualifies for the indicator, and if it does not qualify for the indicator, it will be given a value of 0. Each point for each indicator is then summed for each sample, and the result is divided by the total points of all indicators.

Green Innovation

In this study, green innovation will be measured using several indicators. This makes it possible to measurably evaluate its impact, measure resource use efficiency, assess the reduction of environmental impacts, and monitor overall sustainability performance (Agustia et al., 2019). The researcher has determined the indicators in the study. Each indicator is given 1 point if the firm qualifies for the indicator, and if it does not qualify for the indicator, it will be given a value of 0. Each point for each indicator is then summed for each sample, and the result is divided by the total points of all indicators.

Tobin's Q

Tobin's Q measures the difference between a firm's market value and the book value of its assets, illustrating how well a firm can create long-term value for shareholders (Chouaibi et al., 2019).

Firm Size

Firm size is the size of a firm, which is shown or assessed from total assets, total sales, total profit, tax burden, and others (Halfiyyah & Suriawinata, 2019). This study uses total assets to measure firm size because total assets can provide a complete picture of the firm's ability to adopt ESG practices and green innovation.

Leverage

Leverage is a ratio that describes the firm's ability to fulfill all its obligations (Irfani & Anhar, 2019). Firms with high debt-to-liability ratio calculations may face pressure to meet their financial obligations, affecting their ability to invest in green innovation or ESG practices. On the one hand, companies with high leverage ratios may also be forced to take actions such as ESG and green innovation to meet stakeholder requirements for sustainable development.

Data Analysis Technique

The data analysis technique in this study utilizes multiple linear regression analysis using SPSS 26 statistical software, which first carries out descriptive statistical tests to describe or identify the characteristics of the data collected in such a way. Furthermore, it fulfills the classical assumption tests, including the normality, multicollinearity, heteroscedasticity, and autocorrelation tests. Then, hypothesis testing is carried out, namely, the F test to see whether a regression model is feasible or not, the t-test to find out how the influence of each variable X on variable Y, and the coefficient of determination test to see how much influence variable X has on variable Y compared to other variables outside the study

4. Results

Hypothesis Test

Based on the results of the F test, it is known that the sig value is 0.002 <0.05; through these results, it can be concluded that the regression model is declared feasible. Through the T table n = 57, k = 4, and significance of 0.05, it can be seen that the t-table value = 1.672. Based on Table 2. Environmental, Social, Governance (ESG) obtained a sig value of 0.889> 0.05 and a T value < T table, namely 0.140 < 1.672, which means that environmental, social, governance (ESG) does not affect the firm's financial performance (Tobin's Q). The green innovation obtained a sig value of 0.046 < 0.05 and the value of T count> T table, namely 1.751> 1.672, which means that green innovation can have a positive influence on the firm's financial performance (Tobin's Q). It can be concluded that H1 is rejected and H2 is accepted. Furthermore, firm size obtained a sig value of 0.000 < 0.05 and the value of T count < T table, namely -4.341 <1.672, which means that firm size can have a positive influence on the firm's financial performance (Tobin's Q). Then leverage obtained a sig value of 0.001 <0.05 and a T value> T table, namely 3.612> 1.672, which means that leverage can have a positive effect on the firm's financial performance (Tobin's Q).

Table 1. Hypothesis Test

Variable	Regression Coefficient	t	Significant
Constants	37,924	4.078	0.000
ESG	0.532	0.140	0.889
Green Innovation	3,061	1,751	0.046
Firm Size	-1.290	-4.341	0.000
Leverage	0.866	3.612	0.001
F Significance		0.002	
Adjusted R Square		0.226	

Source: Data processed (2024)

Based on Table 1, the coefficient of determination test results obtained an Adjusted R-Square value of 0.226 or 22.6%. This result means that 22.6% of the firm's financial performance is influenced by environmental, social, and governance (ESG) variables, green innovation, firm size, and leverage. In comparison, the remaining 77.4% is influenced by other variables not discussed in the regression model in this study.

The regression equation above shows a constant value of 37.924, and this means that if ESG, green innovation, firm size, and leverage are constant or do not change, then Tobin's Q variable has a consistent value of 37.924. The ESG coefficient value is known to be 0.532; this figure shows a positive direction, which means that with every increase in ESG by 1 unit, Tobin's Q will increase by 0.532 and vice versa. The green innovation coefficient value shows a positive direction of 3.061, meaning that every increase in green innovation by 1 unit will increase Tobin's Q by 3.061 and vice versa. Then, the firm size coefficient value has a negative direction of - 1.290, meaning that every increase in firm size by 1 unit will reduce Tobin's Q by 1.290 and vice versa. Furthermore, the leverage coefficient value is known to be 0.866; this figure shows a positive direction, which means that with every increase in leverage by 1 unit, Tobin's Q will increase by 0.866 and vice versa.

5. Discussion

The influence of Environmental and Social Governance (ESG) on the firm's financial performance

The results of the data analysis show that ESG does not affect the firm's financial performance. This result is due to the lack of understanding of the ESG concept, which causes companies not to implement ethical business practices, such as sustainability practices and ESG disclosures that have not been carried out fully and thoroughly within the firm (Husada & Handayani, 2021). ESG implementation can also limit a firm's investment options and reduce operational flexibility, which can affect the firm's financial performance in the long run. For example, companies committed to reducing carbon emissions may limit their investment profits to only environmentally friendly

projects, which may have higher costs or generate lower (Zhang et al., 2020). Implementing comprehensive ESG practices requires a significant initial investment in infrastructure, technology, and corporate policies at the expense of the firm's financial returns.

This results in a decline in financial performance before the long-term benefits of ESG practices can be realized (Baran et al., 2022). Firms may also be more likely to allocate their resources to investment in innovation and product development rather than on sustainability aspects (Zhang et al., 2020). This finding is supported by Husada & Handayani (2021) and Baran et al. (2022), which state that applying ESG in the firm does not affect the firm's financial performance.

The effect of green innovation on corporate financial performance

According to the results of the data analysis, green innovation has a positive impact on the firm's financial performance. This result is because green innovation helps companies use resources more efficiently, reduce waste, and optimize production processes. It will impact production costs, ultimately increasing firm profitability (Dai & Xia, 2022). In its application, green innovation can improve the firm's reputation in the eyes of consumers, investors, and other stakeholders because the firm is considered to care about the environment and will have an impact on improving the firm's image, which can help gain long-term profits (Zhang et al., 2020). By adopting green innovation, companies can reduce environmental and regulatory risks by improving the firm's sustainable business practices and complying with strict environmental standards (Zheng et al., 2022).

Implementing green innovation in the firm can help companies develop environmentally friendly products that meet the increasing market needs for sustainable products. Therefore, green innovation creates products and services that are different from their competitors and creates a competitive advantage for the firm, generating additional revenue that will impact financial performance (Agustia et al., 2019). This finding is supported by Aastvedt et al. (2021, Zheng et al. (2022), and Dai & Xia (2022), who state that the application of green innovation in the firm affects the firm's financial performance.

6. Conclusion

This study shows the importance of implementing sustainability principles in the firm and how they impact its financial performance. Many companies today must be more proactive in paying attention to the impact of their corporate activities on the environment and provide positive contributions to society. This finding is because people are increasingly aware of the importance of the environment and social welfare. This study's findings conclude that applying environmental and social governance (ESG) does not affect the firm's financial performance. In contrast, green innovation influences the firm's financial performance, with firm size and leverage as control variables influencing financial performance.

This study implies that companies need to consider implementing sustainability principles, mainly focusing on green innovation, to improve their financial performance. Although green innovation is proven to impact financial performance positively, companies should also.

Pay attention to the thorough implementation of ESG principles to ensure proper social and environmental responsibility. Nonetheless, the findings show that implementing environmental and social governance (ESG) has no significant effect on corporate financial performance, so companies may need to re-evaluate their approach to ESG and focus more on innovation and other strategies that directly impact financial performance. Therefore, companies need to develop and select strategies that are more effective and sustainable in the long term.

Recommendation

Firms are advised to integrate ESG principles comprehensively into their business strategies, including increasing the transparency of ESG disclosures to attract investors and strengthen their reputation. In addition, investments in green innovations, such as environmentally friendly products or energy-efficient technologies, must be strengthened to open up new market opportunities and reduce long-term costs. Regular evaluation of the impact of ESG and green

innovation on financial performance is essential to ensure the sustainability of these initiatives. At the same time, internal training for employees can encourage effective implementation across the organization.

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