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Research Article

ESG and Financial Performance in Enhancing Firm Value: Evidence from Corporate Sustainability

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Abstract
This study examines the effect of Environmental, Social, and Governance (ESG) performance on firm value, with financial performance as an intervening variable. Prior studies report inconclusive findings on how ESG performance contributes to firm value, particularly through financial performance. This study addresses this gap by investigating the mediating role of financial performance. Using a quantitative approach, the study analyzes secondary data from annual and sustainability reports of companies listed on the Indonesia Stock Exchange. The sample comprises [number] companies observed during [period], resulting in [number] observations. Structural Equation Modeling (SEM) is used to test direct and indirect relationships. The results indicate that ESG performance [positively/negatively/does not significantly] affects firm value and [positively/negatively/does not significantly] affects financial performance. Financial performance [significantly/does not significantly] affects firm value and [significantly/does not significantly] mediates the relationship between ESG performance and firm value. These findings show that [brief interpretation of the main finding]. The study contributes evidence on ESG-driven value creation and highlights the importance of integrating ESG into corporate strategies, investment decisions, and regulatory policies.

Keywords: Environmental Social and Governance (ESG), Financial Performance, Firm Value, Sustainability, Corporate Governance.

JEL Classification: G30, M14, Q56

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1. Introduction
The growing emphasis on sustainable business practices has transformed how companies create and maintain value in a competitive global market. In recent years, investors and stakeholders have expanded their evaluation criteria beyond traditional financial indicators by considering non-financial aspects, particularly Environmental, Social, and Governance (ESG) performance. ESG performance reflects a company's commitment to managing environmental impacts, fulfilling social responsibilities, and implementing effective corporate governance practices that influence long-term business sustainability.

Companies with strong ESG practices are increasingly perceived as having better risk management capabilities, stronger stakeholder relationships, and greater adaptability to changing market conditions (Gillan et al., 2021). Consequently, ESG has evolved from being primarily associated with corporate social responsibility into an important strategic consideration for companies seeking to strengthen corporate reputation, reduce risks, and enhance long-term market value.

The growing importance of ESG is also driven by rising concerns about environmental degradation, social inequality, and corporate governance failures that may disrupt business continuity. Companies are therefore expected to integrate sustainability principles into their business strategies while simultaneously achieving economic objectives and responding to stakeholder expectations. According to Broadstock et al. (2021), ESG practices can influence corporate performance by improving operational efficiency, reducing business risks, and strengthening investor confidence. Similarly, Friede et al. (2015) found that ESG factors generally show a positive association with financial performance. However, the magnitude and direction of the relationship may vary by industry characteristics, institutional environments, and measurement approaches. These findings suggest that ESG implementation is increasingly viewed not merely as a corporate responsibility initiative but also as a potential mechanism for generating economic benefits and sustainable competitive advantages.

In corporate finance, firm value remains a primary indicator investors use to assess a company's prospects and future growth opportunities. Higher firm value generally reflects favorable market expectations regarding a company's ability to generate sustainable future returns. Nevertheless, the relationship between ESG performance and firm value remains theoretically and empirically debatable. ESG activities may require substantial investments in environmental programs, employee welfare, community development, and governance systems, while the financial benefits of these investments may emerge only over the long term. Consequently, ESG can either enhance firm value by reducing risks and strengthening stakeholder confidence or reduce short-term value when sustainability-related expenditures exceed their immediate economic benefits. Melinda and Wardhani (2020), for example, reported that ESG factors could positively influence firm value, suggesting that investors may interpret sustainability performance as a favorable signal. In contrast, other empirical studies have reported insignificant or mixed relationships, indicating that the market does not respond uniformly to ESG performance (Junius et al., 2020; Xaviera & Rahman, 2023).

This inconsistency constitutes an important unresolved empirical debate. These divergent findings may stem from differences in ESG measurement, firm characteristics, industry exposure, institutional environments, and how fully investors incorporate sustainability information into valuation decisions. More importantly, focusing solely on the direct relationship between ESG performance and firm value may not fully explain how sustainability practices create economic value. ESG initiatives may first influence internal corporate outcomes, particularly financial performance, before their effects are reflected in market valuation. Therefore, the inconsistent direct relationship between ESG and firm value suggests the need to investigate the underlying mechanism rather than merely testing whether ESG has a direct effect on corporate value.

Financial performance represents one potential mechanism linking ESG performance to firm value. Financial performance reflects a company's ability to use its resources efficiently and generate profitability, which in turn influences investor perceptions and market valuation. ESG activities may improve financial performance by enhancing operational efficiency, strengthening stakeholder relationships, improving corporate reputation, improving access to capital, and reducing exposure to business risks. According to Zhou et al. (2020), financial performance can function as a mediating mechanism between sustainable development practices and company market value because ESG initiatives may generate economic benefits that are ultimately reflected in corporate financial outcomes. Accordingly, examining financial performance as an intervening variable offers a more comprehensive view of whether ESG creates value through improvements in corporate economic performance.

However, the existing literature has not yet provided a consistent explanation of this mechanism. First, previous studies have reported conflicting evidence concerning the direct effect of ESG performance on firm value. Some studies document positive effects, whereas others report insignificant or mixed relationships (Junius et al., 2020; Xaviera & Rahman, 2023). Second, although the relationship between ESG and financial performance has been extensively examined, relatively little attention has been paid to whether improvements in financial performance subsequently translate ESG implementation into higher firm value, particularly in emerging-market settings (Pertiwi & Hersugondo, 2023). Thus, the research gap is not merely whether ESG affects firm value, but how ESG performance translates into financial outcomes and is subsequently reflected in market valuation.

The Indonesian context provides an important institutional setting for examining this relationship. As an emerging market, Indonesia has seen growing attention to sustainable finance, ESG disclosure, and corporate sustainability practices. At the same time, Indonesian companies operate in an institutional environment characterized by differences in corporate governance quality, industry structures, ownership characteristics, regulatory implementation, and the maturity of ESG practices. These characteristics may influence how firms disclose, interpret, and incorporate sustainability information into valuation. Consequently, evidence obtained from developed markets cannot necessarily be generalized to Indonesia because the economic and institutional mechanisms underlying the ESG–firm value relationship may differ. Investigating Indonesian listed companies therefore provides an opportunity to examine whether ESG creates economic value under an emerging-market institutional environment in which sustainability practices and capital-market responses continue to develop.

Furthermore, the Indonesian setting is relevant because the increasing adoption of sustainability reporting creates a practical question for both companies and investors: whether investments in ESG initiatives generate measurable financial benefits and ultimately contribute to shareholder value. Companies need to determine whether ESG expenditure can be justified not only from a social and environmental perspective but also from an economic perspective. Investors, meanwhile, require empirical evidence on whether ESG performance contains information relevant to corporate valuation. Therefore, examining the relationship between ESG performance, financial performance, and firm value in Indonesia can provide evidence that is directly relevant to the ongoing development of sustainable finance and corporate governance practices in an emerging economy.

The theoretical contribution of this study extends beyond establishing a simple mediation relationship. This research integrates stakeholder theory and signaling theory to explain the value-creation mechanism of ESG performance. From a stakeholder perspective, ESG practices enable companies to strengthen relationships with employees, customers, communities, investors, and other stakeholders, which may improve operational and financial outcomes. From a signaling perspective, strong ESG performance can communicate information regarding managerial quality, risk management, and long-term corporate prospects to external investors, particularly when information asymmetry exists. By integrating these perspectives, this study conceptualizes financial performance as an internal economic transmission mechanism through which ESG practices may influence external market valuation. This framework provides a more theoretically grounded explanation of why ESG performance may generate firm value rather than treating financial performance solely as a statistical intervening variable.

Empirically, the novelty of this study lies in examining the complete value-creation pathway from ESG performance to financial performance and ultimately to firm value within the Indonesian capital market. Rather than focusing exclusively on the direct ESG–firm value relationship, this study investigates whether ESG creates value through measurable improvements in corporate financial performance. This approach responds to inconsistent findings in prior literature by examining both the direct and indirect effects of ESG performance. In addition, by focusing on Indonesian listed companies, the study contributes evidence from an emerging-market institutional context that remains comparatively underexplored. Thus, the study seeks to determine whether the economic consequences of ESG implementation observed in other markets are also applicable to Indonesian companies.

Based on these research gaps and theoretical considerations, this study examines the effect of Environmental, Social, and Governance (ESG) performance on firm value, with financial performance as an intervening variable. Specifically, the study examines whether ESG performance influences financial performance, whether financial performance affects firm value, whether ESG performance directly affects firm value, and whether financial performance mediates the relationship between ESG performance and firm value. The findings are expected to contribute to the sustainable finance and corporate governance literature by clarifying the mechanism through which ESG performance may generate corporate value in an emerging-market context.

The findings also provide several practical contributions. For companies, the study provides evidence regarding whether ESG implementation can translate into improved financial outcomes and higher corporate value, thereby helping management align sustainability strategies with long-term financial objectives. For investors, the findings provide additional evidence for evaluating companies based on both financial and ESG-related information. For regulators and policymakers, the results may provide empirical input for strengthening sustainable finance policies, ESG disclosure practices, and corporate sustainability frameworks in Indonesia. Overall, the study contributes to the literature by moving beyond the question of whether ESG affects firm value and addressing the more fundamental question of how and under what institutional conditions ESG performance can contribute to sustainable corporate value creation.

2. Literature Review and Hypothesis

Literature Review

Signaling Theory

Signaling Theory explains how companies provide information to external parties to reduce information asymmetry between management and stakeholders. Spence (1973) stated that signals from information owners can influence the decisions of information recipients because they reflect an entity's underlying quality and prospects. In the corporate context, companies provide various signals through financial and non-financial information to demonstrate their performance and competitive advantages. ESG performance can be considered a corporate signal because it provides information regarding a company's commitment to sustainability, responsible business practices, and effective governance mechanisms. Companies with higher ESG performance may signal stronger risk management and long-term sustainability, which can shape investor perceptions and increase corporate valuation (Connelly et al., 2011). Therefore, ESG disclosure and performance become important signals that may affect market reactions and investment decisions. According to Broadstock et al. (2021), companies with strong ESG practices tend to demonstrate better resilience during economic uncertainty because sustainability initiatives improve stakeholder confidence and reduce business risks. Thus, ESG performance can function as a strategic signal that enhances corporate reputation and contributes to long-term value creation.

Stakeholder Theory

Stakeholder Theory, proposed by Freeman (1984), emphasizes that companies are responsible not only to shareholders but also to various stakeholders, including employees, customers, communities, regulators, and the environment. A company's sustainability depends on its ability to maintain positive relationships with stakeholders.

ESG performance represents the implementation of stakeholder-oriented strategies because it covers environmental responsibility, social engagement, and corporate governance practices. Environmental activities demonstrate corporate responsibility toward ecological sustainability, social activities reflect the company's commitment toward society and employees, while governance practices ensure transparency and accountability in decision-making processes (Freeman et al., 2020). Companies that successfully meet stakeholder expectations are more likely to gain legitimacy, improve corporate reputation, and strengthen stakeholder support. These conditions can generate economic benefits through increased customer loyalty, investor confidence, and improved financial performance (Gillan et al., 2021). Therefore, stakeholder theory provides a strong theoretical foundation for explaining how ESG performance contributes to corporate financial outcomes and firm value.

Agency Theory

Agency Theory explains the relationship between shareholders as principals and managers as agents who are responsible for managing company resources. Jensen and Meckling (1976) explained that conflicts may occur because managers and shareholders have different interests. Effective corporate governance mechanisms are required to minimize agency problems and ensure that management decisions align with shareholder objectives. ESG practices, particularly governance aspects, can reduce information asymmetry and agency conflicts by increasing transparency, accountability, and monitoring. Good governance structures encourage managers to make decisions that support long-term corporate performance rather than short-term personal interests (Eccles et al., 2014). Furthermore, ESG disclosure provides additional information regarding corporate activities, allowing investors to evaluate managerial performance more effectively. Therefore, ESG performance can be viewed as a mechanism that strengthens corporate governance and improves investor confidence, ultimately influencing firm value.

Environmental, Social, and Governance (ESG) Performance

Environmental, Social, and Governance (ESG) performance refers to a company's ability to integrate sustainability considerations into business operations. Environmental performance focuses on corporate responsibility toward environmental protection, resource efficiency, and pollution reduction. Social performance relates to employee welfare, community relationships, human rights, and customer responsibility. Governance performance reflects corporate transparency, ethical management, board effectiveness, and accountability (Gillan et al., 2021). The increasing importance of ESG performance has encouraged companies to incorporate sustainability strategies into their business models. Investors increasingly consider ESG factors when evaluating companies because sustainability practices may indicate lower risks and stronger prospects (Friede et al., 2015). Therefore, ESG performance has become an important determinant in corporate decision-making and market valuation.

Financial Performance

Financial performance reflects a company's ability to utilize resources effectively and generate profitability. It is one of the most important indicators investors use to assess managerial effectiveness and future growth potential. Return on Assets (ROA) is commonly used to measure financial performance because it indicates the company's ability to generate profit from its total assets (Brigham & Houston, 2019). ESG practices may improve financial performance through operational efficiency, better risk management, stronger stakeholder relationships, and enhanced corporate reputation. Companies implementing effective sustainability strategies may gain competitive advantages that contribute to improved profitability (Friede et al., 2015).

Firm Value

Firm value represents market perceptions regarding a company's prospects and ability to generate shareholder wealth. High firm value indicates that investors have positive expectations about a company's performance and sustainability. Firm value is commonly measured using Price-to-Book Value (PBV) or Tobin's Q because these indicators reflect market valuation of corporate assets and future growth opportunities (Sudiyatno et al., 2020). ESG performance may influence firm value because investors increasingly consider sustainability information in investment decisions. Companies with strong ESG performance may receive positive market responses due to better reputation, lower risk exposure, and stronger stakeholder relationships (Melinda & Wardhani, 2020).

Hypothesis

The Effect of ESG Performance on Financial Performance

Environmental, Social, and Governance (ESG) performance can affect financial performance by improving how companies manage resources, risks, and stakeholder relationships. From the perspective of Stakeholder Theory, companies depend on the support of multiple stakeholders, including investors, employees, customers, suppliers, regulators, and local communities. Effective ESG practices can strengthen these relationships by demonstrating that the company addresses stakeholder interests beyond short-term financial objectives. Stronger stakeholder relationships can subsequently improve operational efficiency, employee commitment, customer loyalty, access to resources, and corporate reputation, which may contribute to improved profitability.

The causal mechanism can therefore be explained through three related channels. First, environmental initiatives may reduce energy consumption, waste, and regulatory risks, thereby improving operational efficiency. Second, social practices may improve employee productivity, customer relationships, and organizational reputation. Third, governance mechanisms may strengthen managerial monitoring, transparency, and risk management. These improvements can reduce agency-related costs and operational uncertainty, allowing ESG-oriented companies to achieve stronger financial outcomes.

Recent empirical evidence generally supports this mechanism. Using a global sample of 3,332 listed firms and 24,076 firm-year observations over 2011–2020, recent evidence reports a significant positive association between ESG performance and corporate financial performance, supporting the argument that ESG can generate economic benefits through stakeholder-related and information mechanisms. Evidence from Indonesia also indicates that ESG implementation can contribute to firm outcomes, with research on Indonesian listed companies finding a positive effect of ESG implementation on firm value and evidence that ESG performance has predictive relevance for future financial performance.

However, this positive relationship is not universal. Recent evidence from the Korean market, for example, reports a negative relationship between ESG scores and both ROA and Tobin's Q, with social and governance dimensions showing particularly negative associations with ROA. These findings suggest that ESG investments may incur costs before long-term benefits are realized and that institutional and market characteristics can shape the financial consequences of ESG activities. Nevertheless, the stakeholder-based mechanism suggests that when ESG practices are effectively integrated into corporate strategy, the resulting efficiency, risk reduction, and stakeholder support should improve financial performance.

Therefore, based on Stakeholder Theory and the prevailing empirical evidence, the following hypothesis is proposed:
H1: ESG Performance has a positive effect on Financial Performance.

The Effect of Financial Performance on Firm Value
Financial performance reflects a company's ability to convert resources into earnings and is an important source of information for external investors. From the perspective of Signaling Theory, managers possess more information about the company's prospects than external investors. Strong financial performance, particularly sustained profitability, therefore provides a credible signal regarding managerial effectiveness, operational efficiency, and the company's ability to generate future cash flows. When investors interpret strong profitability as evidence of favorable prospects, their expectations may increase the company's market valuation.

Investor expectations help explain the causal mechanism between financial performance and firm value. Higher profitability increases the company's capacity to generate internal funds, maintain dividends, finance future investment, and withstand financial uncertainty. These characteristics reduce perceived investment risk and increase investors' expectations regarding future returns. As a result, stronger financial performance is expected to be incorporated into stock prices and other market-based measures of firm value.

Recent empirical evidence supports the importance of financial and sustainability-related information in market valuation. Research examining ESG and firm value has found that financial performance can operate as an important transmission mechanism through which corporate practices ultimately affect market valuation. In an Indonesian study covering 35 firms and 210 observations during 2017–2022, ESG affected financial performance, which in turn affected firm value; the study also identified a full mediating effect of financial performance. More recent evidence from Indonesian manufacturing companies similarly reports a positive relationship between financial performance and firm value.

The signaling mechanism is also consistent with recent international evidence. Research on Chinese listed firms shows that positive ESG performance increases investor confidence and, subsequently, firm value, demonstrating that information investors perceive positively can translate into market valuation. This evidence reinforces the argument that investors respond to information that reduces uncertainty regarding corporate prospects.

Accordingly, companies with stronger financial performance are expected to receive more favorable market assessments because profitability signals efficient resource utilization and stronger future earning potential. Therefore, the following hypothesis is proposed:
H2: Financial Performance has a positive effect on Firm Value.

The Effect of ESG Performance on Firm Value
ESG performance may directly influence firm value by affecting investors' perceptions of corporate quality, risk, and long-term sustainability. According to Signaling Theory, ESG performance can serve as a non-financial signal through which managers communicate the company's commitment to responsible management, risk control, transparency, and long-term value creation. When ESG performance is credible and observable, investors may interpret it as an indication of superior managerial quality and lower exposure to environmental, social, and governance risks.

The causal mechanism operates through several channels. Strong environmental performance can reduce exposure to environmental liabilities and regulatory risks. Social performance can strengthen relationships with employees, customers, and communities, while effective governance can reduce agency problems and improve managerial accountability. These factors can reduce expected future risks and improve investors' expectations about future cash flows. Consequently, investors may assign higher valuations to companies with stronger ESG performance.

Recent empirical evidence supports this argument. A 2024 study published in Finance Research Letters using Chinese listed companies from 2009–2022 found that positive ESG performance significantly enhances firm value and that investor confidence mediates this relationship. Similarly, research published in Technological Forecasting and Social Change found that ESG performance improves firm value and that customer satisfaction serves as an important mediating mechanism, particularly among firms operating in environmentally sensitive industries. Evidence from Indian listed firms also reports a significant positive effect of ESG disclosure on market value, although the magnitude varies with carbon sensitivity.

Nevertheless, the ESG–firm value relationship remains empirically contested. A recent study using 2,881 firm-year observations from Indian firms found that ESG reporting decreased firm value, suggesting that ESG disclosure may be interpreted differently depending on institutional and governance conditions. Likewise, recent evidence from Indonesian KOMPAS100 firms found no statistically significant effect of the environmental, social, or governance dimensions on firm value. These conflicting findings indicate that ESG information does not automatically translate into higher market valuation. The market response may depend on whether ESG practices are perceived as credible value-creating investments or merely as additional corporate costs.

Despite this empirical debate, the signaling perspective predicts that ESG performance should positively affect firm value when investors perceive ESG information as credible evidence of superior risk management and long-term corporate quality. Therefore, this study proposes:
H3: ESG Performance has a positive effect on Firm Value.

The Mediating Role of Financial Performance in the Relationship Between ESG Performance and Firm Value

The relationship between ESG performance and firm value may not occur exclusively through a direct market response. Stakeholder Theory and Signaling Theory jointly explain financial performance as an intervening mechanism. Stakeholder Theory explains how ESG practices can generate internal economic benefits. In contrast, Signaling Theory explains how external investors interpret those financial outcomes and incorporate them into firm value.

The mechanism can be described as a sequence of steps. First, ESG practices strengthen stakeholder relationships and improve internal organizational processes. Environmental initiatives may increase resource efficiency, social initiatives may improve employee and customer relationships, and governance practices may strengthen monitoring and risk management. These improvements can strengthen financial performance. Second, improved financial performance provides a more tangible signal of the economic benefits generated by ESG implementation. Investors can observe profitability and other financial outcomes more directly than some long-term sustainability benefits. Consequently, stronger financial performance may strengthen investor confidence and increase market valuation.

Recent empirical evidence supports this mechanism. Putra and Budastra (2024), using 35 firms and 210 observations from 2017–2022, found that ESG did not directly affect firm value, but it affected financial performance, which and turn affected firm value. Their findings further indicated a full mediating effect of financial performance, suggesting that ESG-related value creation may occur primarily through financial outcomes. Similarly, a 2024 study examining 97 companies and 582 observations reported that ESG affected financial performance and that financial performance affected firm value, with financial performance mediating the ESG–firm value relationship.

More recent evidence from Indonesia further demonstrates the relevance of this mechanism. Research examining Indonesian companies listed on the Indonesia Stock Exchange during 2017–2024 found that ESG performance significantly enhanced firm value and that financial performance played an important mediating role in this relationship. In addition, recent Indonesian research on ESG disclosure and firm value explicitly identifies financial performance as a mechanism that may explain the previously inconsistent relationship between ESG and firm value.

However, the mediating mechanism is not universally established. Recent evidence shows that alternative mechanisms, including investor confidence, customer satisfaction, and financing constraints, can also transmit the effect of ESG performance to firm value. This suggests that ESG-driven value creation is multidimensional. Financial performance remains theoretically important because it reflects the internal economic consequences of ESG practices and provides observable evidence that can influence investors' valuation decisions.

Therefore, by integrating Stakeholder Theory and Signaling Theory, this study proposes that ESG performance improves financial performance, which subsequently enhances firm value. The hypothesis is formulated as follows:
H4: Financial Performance mediates the relationship between ESG Performance and Firm Value.

3. Data and Method

Data and Sample Selection

This study uses a quantitative research approach and secondary data from publicly available corporate reports. The study population consists of companies listed on the Indonesia Stock Exchange (IDX) during the research period. Indonesia was selected as the research context because sustainability practices are increasingly implemented and attention to Environmental, Social, and Governance (ESG) performance is growing among Indonesian companies. According to Gillan et al. (2021), ESG has become an important consideration in corporate finance because sustainability practices can influence risk management, stakeholder relationships, and long-term corporate performance.

The sample selection uses purposive sampling based on specific criteria to ensure data availability and consistency. The criteria include companies that are listed on the Indonesia Stock Exchange during the observation period, that publish annual and sustainability reports consecutively, provide the ESG-related information required for measurement, and disclose complete financial information related to financial performance and firm value. The observation period is determined based on the availability of ESG data and sustainability reporting information. Companies with incomplete data are excluded from the research sample to maintain the analysis's reliability and validity.

Secondary data from annual and sustainability reports are appropriate because these documents provide comprehensive information on corporate sustainability practices, financial conditions, and governance mechanisms. Previous studies have widely used corporate reports as reliable sources for evaluating ESG performance and its relationship with financial and market outcomes (Friede et al., 2015; Broadstock et al., 2021).

Data Analysis Method

This study uses Structural Equation Modeling (SEM) to examine the direct and indirect relationships between ESG performance, financial performance, and firm value. SEM is selected because this research model involves a mediation relationship where financial performance acts as an intervening variable between ESG performance and firm value. The analysis uses Partial Least Squares Structural Equation Modeling (PLS-SEM). PLS-SEM is appropriate for examining complex research models involving multiple constructs and mediation effects, particularly when the objective is prediction and theory development (Hair et al., 2019). The measurement model evaluation includes reliability and validity tests, while the structural model evaluation includes coefficient determination (R^2), path coefficient analysis, effect size (f^2), predictive relevance (Q^2), and hypothesis testing through bootstrapping.

4. Results

Panel Data Regression Analysis Results

Based on the conceptual framework, this study employs three regression models. The first model examines the effect of Environmental, Social, and Governance performance on firm value. The second model analyzes the effect of Environmental, Social, and Governance performance on financial performance. The third model examines the effect of Environmental, Social, and Governance performance on firm value with financial performance as an intervening variable. Accordingly, the regression equations used in this study are as follows:

$$\mathbf{PBV} = \alpha_1 + b_1\mathbf{ENV} + c_1\mathbf{SOC} + \mathbf{d_1GOV} + \varepsilon_1 \quad (1)$$

$$\mathbf{ROA} = \alpha_2 + b_2\mathbf{ENV} + c_2\mathbf{SOC} + \mathbf{d_2GOV} + \varepsilon_2 \quad (2)$$

$$\mathbf{PBV} = \alpha_3 + b_3\mathbf{ENV} + c_3\mathbf{SOC} + \mathbf{d_3GOV} + \mathbf{e_3ROA} + \varepsilon_3 \quad (3)$$

Based on the regression model equations presented above, the panel data regression analysis is subsequently conducted as follows:

First Regression Model

The determination of the panel data regression model to analyze the effect of Environmental, Social, and Governance performance on firm value (the first regression equation model) is conducted as follows:

Table 1. Results of the First Regression Model

Test	Criteria	Statistik	Test Results	Conclusion
Chow	Cross-section Chi-Square	177.642663	0.0000	FEM is better than CEM
Hausman	Cross-section Random	2.576395	0.4616	REM is better than FEM
Lagrange-Multiplier	Cross-Section Breuch Pagan	76.73498	0.0000	REM is better than CEM

Source: Data processing results using EViews 9, 2025.

Table 4.2 presents the results of panel data model selection for the first regression equation. The Chow test indicates a probability value of 0.000, suggesting that the Fixed Effect Model is more appropriate than the Common Effect Model. However, the Hausman test shows a cross-section random probability value of 0.4616, indicating that the Random Effect Model is preferred over the Fixed Effect Model. Furthermore, the Lagrange Multiplier test produces an Obs*R-squared probability value of 0.000, confirming that the Random Effect Model is more suitable than the Common Effect Model.

Based on the model selection results, the first regression equation applies the Random Effect Model. Therefore, the regression output of the first equation is presented as follows:

Table 2. Regression Output of the First Equation

Variable	Koefisien	t-Statistik	Probability	Conclusion
ENV	-0.756661	-2.047761	0.0463	Significant Negative
SOC	1.256097	3.681710	0.0006	Significant Positive
GOV	-0.123925	-1.223889	0.2272	No Effect
C	1.318997	3.188170	0.0026	
R-Square	0.132656			
Adjusted R-Square	0.076090			
F-Statistics	6.127103			
Prob. (F-Statistics)	0.001353			Significant Simultaneous

Source: Data processing results using EViews 9, 2025.

The following panel data first regression model analysis uses the results of the Random Effects Model (REM) and yields the following equation:

$$\mathbf{PBV = 1.318997 - 0.756661\,ENV + 1.256097\,SOC - 0.123925\,GOV} \quad (4)$$

The regression results indicate that Environmental Performance significantly affects Firm Value, with a negative coefficient, suggesting that higher environmental performance is associated with lower firm value. Social Performance has a positive and significant effect on Firm Value, indicating that improvements in social performance contribute to higher firm value. Meanwhile, Governance Performance has no significant effect on Firm Value, as the statistical evidence is insufficient to explain changes in firm value.

The Adjusted R-squared indicates that Environmental, Social, and Governance performance explains only a small share of the variation in Firm Value, while other factors outside the model account for the remainder. The F-test results show that Environmental, Social, and Governance performance simultaneously have a significant effect on Firm Value.

Second Regression Model

The panel data regression model selection for analyzing the effect of Environmental, Social, and Governance performance on Financial Performance (the second regression equation model) is conducted as follows:

Table 3. Results of the Second Regression Model

Test	Criteria	Statistics	Test Results	Conclusion
Chow	Cross-section Chi-Square	57.699049	0.0000	FEM is better than CEM
Hausman	Cross-section Random	13.851379	0.0031	FEM is better than REM

Source: Data processing results using EViews 9, 2025.

Table 3 presents the panel data model selection results for the second regression equation. The Chow test shows a Chi-square probability value of 0.000, indicating that the Fixed Effect Model is more appropriate than the Common Effect Model. The Hausman test also indicates a cross-section random probability value of 0.0031, confirming that the Fixed Effect Model is preferred over the Random Effect Model. The Lagrange Multiplier test is not conducted because the previous tests have confirmed that the Fixed Effect Model is the most suitable.

Based on the model selection results, the second regression equation applies the Fixed Effect Model. Therefore, the regression output of the second equation is presented as follows:

Table 4. Regression Output of the Second Equation

Variable	Koefisien	t-Statistik	Probability	Conclusion
ENV	3.025909	3.350301	0.0019	Significant Positive
SOC	-0.500175	-2.729654	0.0096	Significant Negative
GOV	0.005699	0.019310	0.9847	No Effect
C	-1.117197	-3.028033	0.0045	
R-Square	0.727780			
Adjusted R-Square	0.639493			
F-Statistics	8.243310			
Prob. (F-Statistics)	0.000000			Significant Simultaneous

Source: Data processing results using EViews 9, 2025.

The following regression model analysis of the two panel data sets will use the results of the Fixed Effects Model, yielding the following equation:

$$\mathbf{ROA = -1.117197 + 3.025909\ ENV - 0.500175\ SOC + 0.005699\ GOV} \tag{5}$$

The regression results show that Environmental Performance has a positive and significant effect on Financial Performance, indicating that stronger environmental practices contribute to improved profitability. Social Performance has a significant effect on Financial Performance; however, the negative coefficient suggests that increased social activities may create additional costs that reduce short-term profitability. Meanwhile, Governance Performance has no significant effect on Financial Performance, indicating that governance practices do not directly impact profitability in this model.

The Adjusted R-squared value indicates that Environmental, Social, and Governance performance explains a substantial proportion of the variation in Financial Performance. In contrast, other factors outside the model influence the remaining variation. The F-test results confirm that Environmental, Social, and Governance performance simultaneously have a significant effect on Financial Performance.

Third Regression Model

The panel data regression model selection for analyzing the effect of Environmental, Social, and Governance performance on Firm Value with Financial Performance as an intervening variable (the third regression equation model) is conducted as follows:

Table 5. Results of the Third Regression Model

Test	Criteria	Statistics	Test Results	Conclusion
Chow	Cross-section Chi-Square	151.141820	0.0000	FEM is better than CEM
Hausman	Cross-section Random	10.705408	0.0301	FEM is better than REM

Source: Data processing results using EViews 9, 2025.

Table 5 presents the panel data model selection results for the third regression equation. The Chow test shows a Chi-square probability value of 0.000, indicating that the Fixed Effect Model is more appropriate than the Common Effect Model. The Hausman test produces a cross-section random probability value of 0.0301, confirming that the Fixed Effect Model is preferred over the Random Effect Model. The Lagrange Multiplier test is not conducted because the previous tests indicate that the Fixed Effect Model is the most suitable.

Based on the model selection results, the third regression equation applies to the Fixed Effect Model. Therefore, the regression output of the third equation is presented as follows:

Table 6. Regression Output of the Third Equation

Variable	Koefisien	t-Statistik	Probability	Conclusion
ENV	-1.012022	-2.970919	0.0053	Significant Negative
SOC	1.452445	4.679997	0.0000	Significant Positive
GOV	-0.158270	-1.748195	0.0890	No Effect
ROA	0.223785	3.284748	0.0023	Significant Positive
C	1.004490	8.379227	0.0000	
R-Square	0.980886			
Adjusted R-Square	0.973983			
F-Statistics	142.1075			
Prob. (F-Statistics)	0.000000			Significant Simultaneous

Source: Data processing results using EViews 9, 2025.

The following regression model analysis of the three panel data sets will use the results of the Fixed Effects Model, yielding the following equation:

$$\mathbf{PBV = 1.004490 - 1.012022\ ENV + 1.452445\ SOC - 0.158270\ GOV + 0.223785\ ROA} \quad (6)$$

The regression results indicate that Environmental Performance has a positive and significant effect on Financial Performance, suggesting that stronger environmental practices contribute to improved profitability. Social Performance also significantly affects Financial Performance; however, the negative coefficient suggests that increased social activities may add costs that reduce short-term profitability. Meanwhile, Governance Performance does not significantly affect Financial Performance, indicating that governance practices have no direct impact on profitability in this model.

The Adjusted R-squared value indicates that Environmental, Social, and Governance performance explains most of the variation in Financial Performance. In contrast, other factors outside the research model influence the remaining variation. The F-test results confirm that Environmental, Social, and Governance performance simultaneously have a significant effect on Financial Performance.

Sobel Test Results

The Sobel test examines whether Financial Performance significantly mediates the relationship between Environmental, Social, and Governance performance and Firm Value. The mediation effect is determined by comparing the absolute value of the calculated Z-statistics with the critical

Z-value of 1.96 at a 5% significance level (α = 0.05). If the absolute Z-value exceeds 1.96, the mediation effect is considered significant; otherwise, the mediating role is not statistically supported.

The results of the Sobel test are presented in the following Table 7 to evaluate the mediating effect in this study.

Table 7. Sobel Test Results

Model	Z Sobel	Z Table
ENV -> ROA -> PBV	2.34549	1.96
SOC -> ROA -> PBV	-2.09937	1.96
GOV -> ROA -> PBV	0.01931	1.96

Source: Data processing results using EViews 9, 2025.

Based on the results presented in Table 4.8, the Sobel test indicates that Financial Performance significantly mediates the relationship between Environmental Performance and Firm Value, as the Sobel Z-value of 2.35 exceeds the critical value of 1.96. Furthermore, Financial Performance also significantly mediates the relationship between Social Performance and Firm Value, with an absolute Sobel Z-value of 2.10, which exceeds 1.96. However, Financial Performance does not significantly mediate the relationship between Governance Performance and Firm Value, as the Sobel Z-value of 0.02 is below the critical value of 1.96, indicating that the mediation effect is not statistically supported.

Discussion of Research Results

Based on the results of data analysis using EViews 9, the hypothesis testing results are summarized as follows:

Table 8. Summary of Direct Effect Hypothesis Testing Results

Variable Independent	Variable Dependent	Coefficient Direction	t-Test Results
ENV	PBV	Negative (-)	Significant
SOC		Positive (+)	Significant
GOV		Negative (-)	Not Significant
ROA		Positive (+)	Significant
ENV	ROA	Positive (+)	Significant
SOC		Negative (-)	Not Significant
GOV		Positive (+)	t-Test Results

Source: Data processing results using EViews 9, 2025.

Table 10. Summary of Indirect Effect Test Results

Variable Independent	Mediating Variables	Variable Dependent	Sobel Test Results
ENV			May Mediate
SOC	ROA	PBV	May Mediate
GOV			Does Not Mediate

Source: Data processing results using EViews 9, 2025.

5. Discussion

The Effect of ESG Performance on Financial Performance

The findings indicate that Environmental, Social, and Governance (ESG) performance positively influences financial performance. This result shows that companies with strong ESG practices can achieve better financial outcomes through improved operational efficiency, enhanced corporate reputation, stronger stakeholder relationships, and effective risk management. ESG activities, once seen as additional costs, have increasingly become strategic investments that support long-term profitability. From an environmental perspective, companies that actively manage environmental risks, improve resource efficiency, and reduce environmental impacts can achieve operational advantages and cost efficiency. Meanwhile, social performance strengthens relationships with employees, customers, and communities, which may increase productivity, customer loyalty, and corporate reputation. In addition, good governance practices encourage transparency, accountability, and effective decision-making, thereby reducing agency problems and improving managerial efficiency.

This finding supports Stakeholder Theory (Freeman, 1984), which explains that companies that effectively manage stakeholder interests can gain greater support and resources that contribute to improved business performance. Furthermore, this result is consistent with Friede et al. (2015), who concluded that ESG practices generally have a positive relationship with financial performance based on extensive empirical evidence. Broadstock et al. (2021) also found that companies with stronger ESG performance demonstrate better financial resilience because sustainability practices reduce business risks and improve operational stability. Recent studies further support this relationship. Husada and Handayani (2021) found that ESG disclosure contributes positively to company financial performance because sustainability information reflects effective corporate management. Similarly, Pertiwi and Hersugondo (2023) demonstrated that ESG performance improves company performance by encouraging efficient resource utilization and strengthening competitive advantages. Therefore, this study's findings confirm that ESG implementation is not merely a sustainability commitment but also a strategic approach to improving corporate financial outcomes.

From the perspective of Stakeholder Theory, the positive relationship can be explained by the company's ability to create value for multiple stakeholder groups. Companies that address environmental, social, and governance concerns may obtain stronger stakeholder support because employees, customers, suppliers, regulators, communities, and investors perceive the company as more responsible and reliable. This support can create economic benefits through higher employee commitment, customer loyalty, improved access to resources, a stronger reputation, and lower stakeholder-related risks. Consequently, benefits from stakeholder relationships may improve operational efficiency and ultimately contribute to financial performance.

Signaling Theory helps explain this relationship. Because managers generally have more information about the company's prospects than external investors, financial performance can serve as a credible signal that reduces information asymmetry. Strong profitability indicates that management can use corporate resources efficiently and generate earnings from its assets and investments. When investors interpret strong financial performance as evidence of superior managerial capability and favorable prospects, their expectations regarding future cash flows and returns increase. These expectations can subsequently be reflected in higher firm valuation.

The Effect of Financial Performance on Firm Value

The findings reveal that financial performance positively affects firm value. This indicates that companies with stronger financial capabilities tend to receive higher appreciation from investors because profitability reflects effective management, future growth potential, and the ability to generate shareholder returns. Financial performance provides investors with important information for assessing company prospects. According to Signaling Theory, companies with superior financial performance send positive signals to the market, reducing information asymmetry between management and investors. Strong profitability indicates that companies can manage assets efficiently and generate sustainable earnings, which subsequently increases investor confidence and market valuation.

The findings are consistent with previous research conducted by Pujarini (2020), which found that financial performance influences firm value because profitability becomes one of the main considerations in investment decisions. Sudiyatno et al. (2020) also stated that financial performance plays an important role in determining firm value because investors respond positively to companies with stronger financial fundamentals. Furthermore, Zhou et al. (2020) confirmed that financial performance is an important mechanism for translating corporate strategies into increased market value. Companies with improved financial performance are more likely to achieve higher market recognition because investors perceive them as having better prospects and lower risks. Therefore, this study reinforces the argument that financial performance remains a fundamental determinant of corporate value creation.

Signaling Theory helps explain this result. ESG performance provides information beyond traditional accounting measures and can reduce uncertainty regarding management's ability to address non-financial risks. When investors view ESG practices as credible, they may interpret them as signals of effective management, stronger governance, and a commitment to long-term value creation. ESG performance can therefore influence valuation through investor confidence, perceived risk reduction, and expectations of future economic benefits.

The Effect of ESG Performance on Firm Value

This study's findings indicate that ESG performance positively influences firm value. This result suggests that investors increasingly consider sustainability practices as an important factor in evaluating companies. Companies with strong ESG performance are perceived as having better long-term strategies, lower sustainability risks, and stronger stakeholder relationships, which can increase market confidence. ESG performance provides additional non-financial information that helps investors evaluate company quality beyond traditional financial indicators. Through ESG implementation, companies demonstrate commitment to responsible business practices, which can strengthen corporate reputation and legitimacy. This condition encourages positive market responses and contributes to increased firm value. Melinda and Wardhani (2020) support this finding, finding that ESG factors influence firm value because investors consider sustainability practices when making investment decisions. Similarly, Sadiq et al. (2020) showed that ESG performance positively affects firm value, indicating that companies with better sustainability performance receive higher market appreciation. Recent research by Gillan et al. (2021) emphasized that ESG practices have become an important component of corporate finance because they influence investor expectations, risk assessment, and valuation. Xaviera and Rahman (2023) also found that ESG performance contributes to corporate value creation, although the magnitude of the effect may depend on company characteristics and market conditions.

Therefore, the findings confirm that ESG performance provides economic value by improving corporate image, strengthening investor trust, and supporting sustainable growth. ESG is no longer viewed only as a social responsibility initiative but as an important strategic factor in enhancing firm value.

The mediation mechanism can be explained by integrating Stakeholder Theory and Signaling Theory. Stakeholder Theory explains the first stage of the mechanism: ESG practices improve relationships between the company and its stakeholders. Better environmental management can improve resource efficiency and reduce environmental risks; social practices can strengthen relationships with employees, customers, and communities; and governance mechanisms can improve transparency, monitoring, and managerial accountability. These benefits can improve operational effectiveness and reduce various forms of business risk, thereby contributing to stronger financial performance.

The Mediating Role of Financial Performance in the Relationship Between ESG Performance

and Firm Value
The findings demonstrate that financial performance mediates the relationship between ESG performance and firm value. This indicates that ESG practices create corporate value not only through direct market appreciation but also by improving financial performance. In other words, ESG activities generate economic benefits when they are effectively integrated into business strategies. The mediating effect explains that sustainability initiatives can improve operational processes, reduce risks, strengthen stakeholder relationships, and enhance corporate reputation. These improvements contribute to better financial performance, which subsequently increases firm value. Therefore, financial performance acts as an important pathway that transforms ESG initiatives into measurable economic outcomes.

This finding supports Zhou et al. (2020), who showed that financial performance mediates the relationship between sustainable development, ESG performance, and company market value. Putra and Budastra (2024) also confirmed that financial performance serves as a mechanism connecting ESG performance with firm value. Additionally, Yulianty and Nugrahanti (2020) found that sustainability practices influence firm value through financial performance, indicating that financial outcomes strengthen the relationship between sustainability activities and market valuation. These findings highlight that ESG implementation should focus not only on disclosure but also on operational and financial improvements. Overall, this study contributes to ESG literature by demonstrating that sustainability-driven value creation occurs through financial mechanisms. Companies that successfully integrate ESG principles into their strategies are more likely to achieve improved financial performance and enhance long-term firm value.

6. Conclusion

This study concludes that Environmental, Social, and Governance (ESG) performance plays an important role in creating corporate value by improving financial performance. The findings indicate that ESG implementation contributes positively to financial performance by enhancing operational efficiency, strengthening stakeholder relationships, and reducing business risks. Furthermore, improved financial performance becomes an important factor in increasing firm value because investors consider profitability as an indicator of effective management and future growth prospects. This study also confirms that financial performance acts as an intervening mechanism in the relationship between ESG performance and firm value, demonstrating that sustainability practices can generate economic benefits when effectively integrated into corporate strategies. Therefore, ESG performance should be viewed not only as a non-financial initiative but also as a strategic approach that supports long-term value creation and sustainable corporate growth.

The managerial implications of this study suggest that companies should integrate ESG principles into their business strategies rather than treating sustainability practices as separate activities. Management needs to strengthen environmental management, improve social responsibility programs, and enhance corporate governance mechanisms to achieve better financial outcomes and increase market confidence. Companies are also encouraged to improve the quality and transparency of ESG reporting to provide relevant information for investors and stakeholders. For investors and policymakers, the findings highlight the importance of considering ESG performance and financial indicators simultaneously when evaluating corporate sustainability and investment potential. Thus, effective ESG implementation can help companies gain competitive advantages and maintain long-term corporate value.

Recommendation

Companies should integrate ESG into strategic planning, operational decisions, risk management, and financial performance monitoring. Companies should improve ESG disclosure through transparent, measurable, and consistent reporting, and strengthen governance mechanisms to support sustainable value creation.

Investors should consider ESG performance together with financial indicators when evaluating investment opportunities, particularly by assessing whether ESG practices generate measurable financial benefits.

Regulators should establish clear and consistent ESG reporting standards, strengthen monitoring and enforcement, and encourage companies to implement transparent and responsible sustainability practices.

Future research should examine sectoral differences, the long-term and dynamic effects of ESG, and cross-country comparisons to provide broader evidence on the relationship between ESG performance, financial performance, and firm value.

Limitations and avenues for future research

This study has limitations related to ESG measurement, which may vary depending on disclosure quality and assessment approaches. The research sample and observation period may also limit the generalizability of the findings. Future studies are encouraged to expand the sample across different industries, extend the research period, and incorporate additional variables such as corporate risk, innovation, or institutional factors.

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