AFRE Accounting and Financial Review, 6(1): 139-147, 2023
https://jurnal.unmer.ac.id/index.php/afr

The Impact of ESG Risk Scores on Firm Value: Foreign Ownership as A Moderating Role

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Article info

Keywords:
ESG Risk Scores; Firm's Value; Foreign Ownership

Abtract

The objective of this research is to determine the effect of Environmental, Social, and Governance (ESG) risk scores on firm's value (Tobin's Q) and determine the role of foreign ownership in the relationship between ESG risk scores and firm's value as a moderating variable. This study also uses control variables such as firm age, firm size, profitability proxied by return on assets (ROA), and leverage proxied by debt to equity ratio (DER) to minimize other effect from outside besides the independent variables. The sample of the data is 70 firms listed in the Indonesia Stock Exchange (IDX) and has an ESG risk score by Sustainalytics for the 2021 observation year. Multiple linear regression analysis method is used to prove the research hypothesis. The results showed that the ESG risk score has a significant negative effect on firm's value, it means that the higher ESG risk score owned by the company will lower the firm value. Meanwhile foreign ownership has not been able to moderate the relationship between ESG risk score and firm's value.

ISSN (print): 2598-7763
ISSN (online): 2598-7771

Citation: Istikomah, Rahmawati, dan Amperawati, Dwi Endang.(2023). The Impact of ESG Risk Scores on Firm Value: Foreign Ownership as A Moderating Role. AFRE Accounting and Financial Review, 6(1): 139-147

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JEL Classification: G32, G34, G35.
DOI: https://doi.org/10.26905/afr.v6i1.10109

1. Introduction

The demand for organizations to be more responsible for the environment and society is increasing (Arif et al., 2020). With the increasingly widespread problems related to the climate crisis, supply chains, damage to natural resources, and global welfare, ESG (Environmental, Social, and Governance) aspects are increasingly becoming a concern, this is in line with the increasing desire of investors, regulators, and other interested parties so that the company's business activities can contribute positively to solving these problems (esg.idx.co.id, 2022). It is then important for companies to be able to consider and strive for a healthy, sustainable and responsible business ecosystem.

In line with the ESG (Environmental, Social, and Governance) concept of the UN Global Compact as a standard measure of sustainable corporate performance consisting of environmental, social, and governance criteria. Environmental aspects, referring to the relationship of the organization (company) with the environment in which it operates, including the use of energy by the company, the waste generated from the company's activities, the resources needed, as well as its impact and responsibility for the environment and living things. Social aspects include all matters relating to the company's relationship and role to the public at large. The corporate governance aspect relates to how the company is able to create good business processes, controlled, and compliant procedures to create a responsible and sustainable business climate.

Investors more appreciate companies with good ESG practices, while bad ESG practices are an indicator of risk. Lack of responsible ESG practices by companies can lead to poorly managed investment returns especially in high risk sectors which can pollute the environment or discriminate against employees. ESG integration into corporate investment decisions will assist investors in making decisions based on overall performance rather than just financial performance (Mohammad & Wasiuzzaman, 2021). Continuous investment has proven to be significant in business development and favored by shareholders.

Stock exchange analysis shows that investors are very interested in ESG related activities and dis- closures (Sadiq, 2020). The disclosure of good ESG responsibilities will reduce information asymmetry and can improve investors' perception and recognition of the company. Conversely, companies with high ESG risks that are not accompanied by good responsibility and disclosure will reduce the value of the company itself. Integrating ESG policies and practices into a company's strategy and day-to-day operations is increasingly perceived by investors as relevant to its ability to realize long-term value. Therefore, transparency around how a company manages ESG risks and opportunities is part of its value proposition (SSE Initiative, 2015).

Various studies have shown that the integration of ESG into a company's valuation model improves non-financial indicators such as consumer satisfaction, market acceptance, lower costs of debt and the social values it brings to its stakeholders (Mohammad & Wasiuzzaman, 2021). According to Prof. Roy Sembel - IPMI International Business School Professor as stated on the investor.id, stated that good ESG implementation can have a positive impact on business performance and the sustainability of a company, even the results of Oxford research prove that the implementation of ESG can improve a company’s business performance up to 88% and make the company’s issuer's share price grow by 80%. Furthermore, Prof. Roy also cited Nasdaq research which showed that the ESG program will open up greater access to capital for companies and have an impact on the company's brand (Situmorang, 2021), .

Several studies that have been conducted previously related to ESG show mixed results. Research by Prabawati & Rahmawati (2022) examining the effect of ESG scores on the value of companies in ASEAN found that ESG scores have a negative effect on firm value (Tobin's Q), slightly different from research by (Li, 2022) who raised the ESG risk score, showed the result that a low ESG risk score did not have a significant impact on HPR shares. Meanwhile, research by Ferriani & Natoli (2020) found that low ESG risk has a positive impact on inflows to equity funds during the Covid-19 crisis. Other research by (Priandhana, 2022a) shows that there is a negative influence between ESG risk and company financial performance. In the sense that the higher the ESG risk of a company, the company's financial performance will decrease.

In practice, the implementation of ESG standards in Indonesia itself is also not optimal. Based on the results of a survey conducted by Corporate Knights in 2021, Indonesia's ESG index ranks 36th out of 47 capital markets in the world. This position is far below other ASEAN countries. This is sup-ported by another IBCSD survey which shows that 40% of companies in Indonesia are still not aware of the importance of ESG implementation and risk management (iap2.or.id, 2022).

In this study, the authors also include foreign ownership variables to determine their moderating role with the consideration that foreign investors still dominate the Indonesian equity market with a market share of 51% in 2018 (Dwi Ayuningtyas, 2019), foreign investors are also considered to be more concerned about the environment because they are more aware and obedient to ecological laws (Adeela et al., 2019), besides that foreign investors also have a major influence in determining stock prices in the market (Wang, 2007) so that the involvement of this variable is expected to provide better research results.

Other studies involving moderating variables of foreign ownership show similar results. Research by Muhammad & Aryani (2021) on carbon disclosure on firm value with the moderating role of foreign ownership shows the results that carbon disclosure has a negative effect on firm value, while foreign ownership significantly moderates the relationship between the two variables. Furthermore, research by Amosh (2022) shows that foreign ownership can improve the disclosure of corporate performance in the field of sustainability across all environmental, social, and governance dimensions.

Based on the foregoing, this study will test and analyze more deeply how the influence of ESG risks owned by companies on their value, as well as the extent of the role of foreign ownership as a moderator in the relationship between the two as a consideration that foreign investors have a concern for the environment and are more compliant with ecological laws than local investors (Adeela et al., 2019). The objective of this research is to determine the effect of Environmental, Social, and Governance (ESG) risk scores on firm’s value (Tobin's Q) and determine the role of foreign ownership in the relationship between ESG risk scores and firm's value as a moderating variable.

2. Hypothesis Development

Stakeholder Theory

Based on stakeholder theory, the existence of a company is not limited to an entity that only operates for its own interests, but must also provide benefits to its stakeholders (Ghozali & Chariri, 409). The maximization of stakeholder wealth will lead to an increase in firm value in the long term. Increased corporate value is a product of ethical and responsible corporate behavior that aims to improve the welfare of society.

This theory simply encourages companies to create a business climate that can answer the demands of their stakeholders as well as possible. By recognizing the company's responsibility to all stakeholders, it dynamically increases their support for the sustainability of the company. This responsibility is not only limited to the old orientation and interests of its investors, but also needs to pay attention to social aspects of society, the environment, and governance as part of the company itself.

The Effect of ESG Risk Score on Firm Value

Information disclosure regarding the company's environmental activities increases the legitimacy of the community which has a positive impact on company value. Buallay (2019) states that if environmental, social and governance (ESG) performance is well disclosed, it can reduce the level of business risk that may occur due to practices related to the surrounding social environment carried out by the company and will attract the attention of stakeholders because the company is seen as having a good level of sustainability.

In recent years, social, environmental, and governance (ESG) has become an increasingly important aspect and consideration for investors to invest in companies. Most investors will avoid investing in companies that tend to be risky. Not only investors, other stakeholders such as employees, suppliers, and customers are now starting to consider decisions in the use of company products and services by seeing how capable the company is in reducing the level of business risk. Therefore, a high level of ESG risk will instill a negative image from stakeholders which will then reduce their assessment of the company.

H_1: ESG Risk Score has a negative effect on firm value

The Role of Foreign Ownership in the Relationship between ESG Risk Score and Firm Value

Foreign shareholders are an important pillar for achieving transparency and trust between companies and stakeholders. The presence of foreign ownership can raise stakeholder aspirations. Foreign expertise and knowledge related to technology, governance management, and sustainability and accountability principles can steer corporate policies towards specific agendas, such as sustainable business processes (Amosh, 2022).

Adeela et al (2019) in their research showed that foreign ownership factors play an important role in motivating companies to engage and report on sustainability activities. Foreign investors have environmental concerns and are more compliant with ecological laws than local investors. They are more critical in assessing the level of ESG risk that exists in the company before deciding to provide capital investment. Foreign investors will be more selective in viewing and assessing companies with a high level of ESG risk. This in turn puts greater pressure on companies to maximize stakeholder value by encouraging company administration to respond to their demands and aspirations, including better management of ESG risks.

H_2: Foreign ownership is able to strengthen the negative effect of the ESG risk score on firm value

3. Data and Methods

Population and Sample

The population in this study are all companies listed on the Indonesia Stock Exchange (IDX) in 2021. The purposive sampling technique was used in selecting samples by setting several criteria, namely companies listed on the Indonesia Stock Exchange for the 2021 period and having an ESG risk score by Morningstar Sustainalytics and presenting complete information on the research variables. After processing the sample according to the specified criteria, 70 samples were obtained.

Data Types and Sources

This research is a type of quantitative research with data sources used is secondary data obtained from financial reports, annual reports, sustainability reports, and ESG risk scores by Morningstar Sustainalytics which are available on the Indonesian Stock Exchange (IDX) website, each company's website, as well as other sites that are considered credible to be used as a reference source.

Table 1. Sample Selection Results

Sample Criteria	Total
Companies listed on the Indonesia Stock Exchange (IDX) for the 2021 period and have an ESG Risk Score by Morningstar Sustainalytics	80
The company did not present information on the research variables in full for the 2021 financial year.	(5)
Outlier Data	(5)
Total Sample	70

Source: results of data processing E-Views, 2023

Operational Definition and Variable Measurement

Firm value as the dependent variable in this study reflects how much investment investors entrust to the company and how high its value is in the financial market. This study uses the dependent variable of firm value as measured by the Q ratio or commonly known as Tobin's Q. The formula for calculating this ratio is:

$$\text{Tobin's Q} = \left(\frac{\text{EMV} + \text{D}}{\text{EBV} + \text{D}}\right)$$

Description: EMV is the market value of equity, which is the product of the end-of-period stock price and the number of shares outstanding. EBV is the book value of assets calculated by subtracting total assets from the company's total debt, and D is the company's total debt.

The ESG (Environmental, Social, and Governance) risk score is the independent variable in this study. ESG is measured using the MEIs set, consisting of: MEI.0 Corporate Governance, MEI.1 Access to Basic Services, MEI.3 Bribery and Corruption, MEI.4 Business Ethics, MEI.5 Community Relations, MEI.6 Data Privacy and Security , MEI.7 Emissions, Effluents and Waste, MEI.8 Carbon – Own Operations, MEI.8.PS Carbon – Products and Services, MEI.9 E&S Impact of Products and Services, MEI.12 Human Rights, MEI.12.SC Human Rights – Supply Chain, MEI.13 Human Capital, MEI.14 Land Use and Biodiversity, MEI.14.SC Land Use and Biodiversity – Supply Chain, MEI.16 Occupational Health and Safety, MEI.17 ESG Integration – Financials, MEI .18 Product Governance, MEI.19 Resilience, MEI.20 Resource Use, MEI.20.SC Resource Use – Supply Chain The ESG risk score is a measure of the magnitude of risks related to environmental, social and corporate governance that are not managed. This study uses the ESG risk score that has been carried out by Morningstar Sustainalytics and is available on the Indonesia Stock Exchange's website (Morningstar, 2023)

ESG risk scores are grouped into five (5) risk categories, namely negligible category with a risk score of 0-10, low-risk category with a score of 10-20, medium-risk category with a risk score of 20-30, high-risk category with a risk score of 30-40, and severe-risk category with a risk score of >40. The risk categories are absolute, meaning that a high risk assessment reflects a comparable level of unmanaged ESG risk across all subindustries (Sustainalytics, 2019).

This study uses foreign ownership as a moderating variable to see the contingent effect on the relationship between firm value and ESG risk score. The presence of this variable will change the original relationship between the independent and dependent variables (Uma Sekaran & Roger Bougie, 2016). Foreign ownership is measured by the percentage of ownership with the formula:

$$\text{FOWN} = \left(\frac{\sum foreign\ shares}{\sum outstanding\ shares}\right) x\ 100\%$$

This study uses 4 control variables to minimize the possibility of other influences besides the independent variable on the dependent variable. The four control variables are company age which shows the age of the company since its founding year, company size with market capitalization proxy (number of shares outstanding x stock market price) which represents the size of the company in the stock market, profitability proxied by ROA (net income/total assets), and leverage proxied by DER (total debt/total equity).

This research data is crossection data with multiple linear regression analysis methods using E- views statistical tools. The significance value in this test is 5 (five) percent. The following modeling was developed in this study:

$$TQi = \alpha + \beta1ESGi + \beta2FOWNi + \beta3ESGFOWNi + \beta4AGEi + \beta5SIZEi + \beta6ROAi + \beta7DERi$$

Note: TQ= company value, i= company order, α= constant, β= coefficient, ESG= total ESG risk score, FOWN= foreign ownership, ESGFOWN= product of ESG risk score and foreign ownership, AGE= company age (in years), SIZE= company size (in of market capitalization), ROA= return on assets, DER= debt to equity ratio.

4. **Results**

Descriptive statistics

In table 2, it can be seen that the number of samples in this study was 70. The dependent variable, namely firm value (Tobin's Q) has a maximum value of 6,524 and a minimum value of 0,659. While the average (mean) of Tobin's Q is 1.703. Some companies have a Tobin's Q value <1, which means that the company has a relatively low stock value (under- valued).

The independent variable in the form of ESG risk score has a maximum value of 56,130 and a minimum value of 12,670. The average ESG risk score of the sample companies is 31.132 which means that the company is at an average level of ESG risk with a high category. The moderating variable, namely foreign ownership, has a maximum value of 0.866 and a minimum value of 0.000. The average foreign ownership of sample companies is 0.262 with a standard deviation of 0.224.

Table 2. Descriptive Statistics

Variables	N	Maximum	Minimum	Mean	Std. Dev.
TOBIN'S Q	70	6,524	0,659	1,703	1,202
ESG	70	56,130	12,670	31,132	9,620
FOWN	70	0,866	0,000	0,262	0,224
AGE	70	126,000	8,000	42,271	26,012
LOG SIZE	70	34,433	25,094	30,839	1,534
ROA	70	0,309	-0,017	0,073	1,475
DER	70	15,308	0,133	31,027	5,824

The company age control variable (AGE) has a maximum value of 126 years, while the minimum value is 8 years and the average age of the company is 42 years. Company size (log size) proxied by market capitalization shows a maximum value of 34,433 with a minimum value of 25,094 and an average of 30,839. Profitability proxied by ROA (Return on Asset) has a maximum value of 0.309 with a minimum value of -0.017 and the average ROA of the company is 0.073. Laverage proxied by DER (Debt to Equity Ratio) shows a maximum value of 15.305 with a minimum value of 0.133 and the average company DER is 31.027.

Regression Result of Crossection Data

Based on the regression test results as shown in table 3, it can be seen that the probability value of the F-statistic is 0.000003 (sig <0.05). So it can be concluded that the independent, moderation, and control variables simultaneously affect the de- pendent variable, namely firm value.

Table 3. Regression Testing Results

Variabel	**Koefisien**	**t-Statistic**	**Prob.**
ESG	-0,011923	-2,164238	0,0342
FOWN	-0,043640	-0965425	0,3380
ESGFOWN	-0,013654	-1,416937	0,1615
AGE	-0,006827	-3,288303	0,0017
LOG SIZE	0,137246	3,527224	0,0008
ROA	2,874698	3,443369	0,0010
DER	-0,000424	-1,386403	0,1705
C	-3,491747	-2,804730	0,0067
R-square	0,428522	Mean dependent var	0,360372
Adjusted R-square	0,374096	S.D. dependent var	0,550717
S.E. of regression	0,435695	Sum squared resid	11,95928
F-statistic	7,873424	Durbin-Watson stat	1,927108
Prob (F-statistic)	0,000002		

Partial regression test (t-test)

Based on table 3, the coefficient value of the ESG risk score variable denoted by ESG is -0.011923 with a significance of 0.0342 (sig <0.05). These results indicate a significant negative effect of ESG risk score on firm value, meaning that H_1 is accepted. While testing the moderating variable, namely foreign ownership denoted by FOWN, has a coefficient value of -0.043640 with a significance of 0.3380 (sig <0.05) and its interaction denoted by ESG-FOWN has a coefficient value of -0.013654 with a significance of 0.1615 (sig < 0.05). This means that foreign ownership supports the negative relationship between ESG risk score and firm value (Tobin's Q) but has no significant effect, so H_2 is rejected.

Meanwhile, for the control variable company age shows a negative coefficient value of -0.006827 and significant (0.0017 <0.05) on firm value, company size (LOG SIZE) shows a positive coefficient of 0.137246 and significant (0.0008 <0.05) on firm value, as well as profitability (ROA) which has a coefficient value of 2.874698 and a significance of 0.0010 (<0.05), while leverage (DER) shows a coefficient value of 2.874698 and a significance of 0.0010 (<0.05) on firm value, as well as profitability (ROA) which has a coefficient value of 2.874698 and a significance of 0.0010 (<0.05), while leverage shows a negative coefficient value (- 0.000424) and is not significant (0.1705> 0.05) on firm value.

5. Discussion

The Effect of ESG Risk Score on Firm Value

The test in table 3 previously shows the result that the level of ESG risk of the company has a significant negative influence on the value of the company. This means that the higher the ESG risk of the company, the lower the public's assessment of the company. Companies with a high level of ESG risk reflect the company's failure to manage its business responsibilities in accordance with ESG aspects to satisfy the interests of stakeholders. Table 2 shows that on average the companies sampled in this study have high to severe ESG risks (31.132 - 56.130). Given that stakeholders are an important element in the running of the company, this will certainly reduce public trust (especially investors) and thus will damage the company's reputation. This finding is in line with the initial hypothesis stating that ESG risk score negatively affects firm value.

This result is a reinforcement of previous research, namely as a result of research by Cohen (2023) with his findings that social risk has a negative impact on excess return. However, different results were found from other studies, such as research by (Priandhana, 2022) which states that ESG risk has a negative but insignificant effect on the company's financial performance, ESG risk scores have no effect on hold period return (HRP) at the 5% significance level for S&P 500 stocks.

The Effect of Foreign Ownership in Moderating the Relationship Between ESG Risk Scores on Firm Value

Testing for moderating variables, namely foreign ownership on the effect of ESG risk score on firm value as shown in table 3, it is known that foreign ownership is not sufficiently able to moderate the effect of ESG risk score on firm value. The test results show that foreign ownership has no significant effect in relation to ESG risk score and firm value. The average amount of foreign ownership in the sample companies is 26%, this percentage is not dominant enough when compared to other non-foreign ownership, so the influence of foreign parties is not large enough to provide an assessment of the company's business operations.

Information related to ESG risks owned by the company does not fully provide assurance to foreign investors about whether the company is good or not. Some investors believe that companies that disclose and pay more attention to ESG actually provide confidence that the company justifies that the company incurs high ESG costs (Sadiq, 2020). Of course, this will not be in line with the goals of most investors who still prioritize investment in corporate profits.

6. Conclusions and recommendations

Conclusion

The results found that ESG risk score has a significant negative effect on firm value, which means that the higher the level of ESG risk owned by the company will reduce the value of the company itself. Meanwhile, the presence of foreign ownership has not been able to moderate the influence between ESG risk scores on firm value. This can be interpreted that the consideration of investors in assessing the company by looking at the potential ESG risk has not been the main point. Other factors may be more dominating in their influence on firm value, such as profitability.

Suggestion

Apart from all the findings in this study, there are still some limitations that are expected to be taken into consideration for improvement for future studies. For example, the limited scope of the research sample which only focuses on public companies in Indonesia with the observation year 2021 so that further research can expand the scope of the research sample both from the observation year period and the scope of the observation area. In addition, this study only takes into account the moderating role of foreign ownership. Future research is expected to consider other possible moderators in the relationship, such as market competition.

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