Research Paper

The Impact of ESG Performance on Financial Performance: A Study of Companies in the SRI-KEHATI Index

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Received : Sept 25, 2025	Revised : Oct 2, 2025	Accepted : Oct 2, 2025	Online : October 14, 2025

Abstract

The research investigates how Environmental, Social, and Governance (ESG) performance affects the financial performance of corporations represented in Indonesia's SRI-KEHATI Index. Using a quantitative approach with regression analysis, the research examines ESG scores sourced from Morningstar Sustainalytics, alongside financial metrics such as Return on Assets (ROA), and control variables including debt-to-asset ratio and institutional ownership. The findings reveal that ESG performance, comprising environmental, social, and governance dimensions, does not have a significant direct effect on financial performance in this sample. Conversely, the debt-to-asset ratio significantly influences profitability, whereas institutional ownership shows no measurable impact. The results suggest that the relationship between sustainability efforts and financial outcomes might be more long-term or context-dependent, warranting further research into sectoral and regional variations.

Keywords: *ESG performance, financial performance, SRI-KEHATI, institutional ownership*

INTRODUCTION

This study aims to examine the effect of sustainability performance on corporate financial performance. The issue of sustainability is gaining increasing attention in both global and domestic capital markets. Investors are not only considering financial performance in their investment decisions, but also environmental, social, and governance (ESG) factors. In Indonesia, the Indonesia Stock Exchange and the Kehati Foundation launched the SRI-KEHATI Index, which consists of companies with a strong commitment to sustainability and governance principles.

ESG performance is believed to have a long-term impact on business continuity and company financial performance. Companies that care about the environment, pay attention to social responsibility, and implement good governance tend to have lower risks, good reputations, and are able to attract investors (Kumar & Firoz, 2022; Mohanty et al., 2021; Vivel-Búa et al., 2024; Wu & Abeysekera, 2023). However, the relationship between ESG performance and financial performance is still debatable. Some studies show a positive relationship, while others find a weak or even insignificant relationship (Aydoğmuş et al., 2022).

Financial performance in this study is proxied using Return on Assets (ROA) because it reflects a company's ability to generate profits from the assets it uses. In addition, this study controls for financial structure factors proxied by Debt to Asset Ratio (DAR) and institutional ownership, given that these two factors can influence the relationship between ESG and financial performance

The financial structure illustrates the company's liabilities, while institutional ownership is believed to improve oversight of management, thereby strengthening the relationship between ESG and financial performance. The result of the study shows that ESG reporting has no effect on firm performance (Chen & Xie, 2022).

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LITERATURE REVIEW

Good ESG performance can improve financial performance (Kumar & Firoz, 2022), increase stock returns (Wu & Abeysekera, 2023), and reduce corporate risk (Vivel-Búa et al., 2024) and funding costs (Mohanty et al., 2021). Therefore, companies with good ESG performance have higher sustainability potential, lower incentives to engage in earnings manipulation, and better financial reporting quality.

Companies exhibiting superior ESG performance tend to be larger and more closely observed by external constituents. Grounded in reputation theory, corporate initiatives in ESG disclosure and governance enhancement are not merely compliance-driven but function as strategic tools to preserve legitimacy and protect reputational capital in their industry. In cases of financial fraud, companies with good ESG performance will face more serious consequences, as they receive a higher level of external attention. As a result, companies with good ESG performance tend to be more stringent in controlling the quality of their financial reports (Ahmed et al., 2022). From an environmental performance perspective, the extent of environmental disclosure by companies has a notable impact on the quality of their financial reporting. In terms of governance, good corporate governance improves the quality of financial reporting, which in turn encourages better resource allocation decisions by management (Hasan et al., 2022).

Meanwhile, in terms of social responsibility (Lin et al., 2021), companies that are more socially and ethically responsible tend to have better quality financial reporting. Capital market regulators should use corporate social responsibility (CSR) information as a guide to achieve more optimal capital market resource allocation (Rongbin et al., 2022). In addition, high-quality financial reporting indicates that the likelihood of a company manipulating its profits is low. Based on these arguments, we propose the following hypothesis:

H1: ESG performance positively effect on financial performance.

RESEARCH METHOD

The population of this study comprises all companies included in the SRI KEHATI Index from 2018 to 2023. Established in 2009 through a collaboration between the Indonesian Biodiversity Foundation (KEHATI) and the Indonesia Stock Exchange (IDX), the index tracks the stock performance of 25 publicly listed firms that have shown commitment to Sustainable and Responsible Investment (SRI) principles and Environmental, Social, and Governance (ESG) practices. The research sample was selected from the population based on certain criteria in accordance with the research objectives. These criteria were (1) not a company in the financial and insurance sector, (2) companies with a debt ratio of more than 1 or less than 0 were excluded from the sample, and (3) had complete data.

The study applies dependent, independent, and control variables. The dependent variable, financial performance, is proxied by return on assets (ROA), which reflects a firm's ability to effectively manage its assets to produce earnings. The independent variable, corporate ESG performance, is measured using ESG ratings from Morningstar Sustainalytics, selected for their international credibility and relevance in sustainability-oriented research and investment decisions. The control variables in this study consist of debt to asset ratio and institutional ownership. The hypotheses in this study were tested using regression analysis. The regression model used is as follows:

$$ROA_{it} = \alpha + \beta_1 ENV_{it} + \beta_2 SOC_{it} + \beta_3 GOV_{it} + \beta_4 DAR_{it} + \beta_5 INST_{it} + \varepsilon_{it}$$

Where ROA_{it} is return on assets of firm *i* period *t*; ENV_{it} is the environmental section score in ESG reporting of firm *i* period *t*; SOC_{it} is the social section score in ESG reporting of firm *i* period

t; GOC_{it} is the government section score in ESG reporting of firm *i* period *t*; DAR_{it} is the debt to total asset ratio of firm *i* period *t*; and $INST_{it}$ is the institutional ownership of firm *i* period *t*. The hypothesis is supported if β_1, β_2, and β_3 is significantly positive, which means that ESG performance has been proven to improve financial performance

FINDINGS AND DISCUSSION

Before testing the hypothesis, we first conducted a descriptive statistical analysis. Table 1 shows the results of statistical descriptions of all variables in the regression model.

Table 1. Statistics Descriptive of Variables

Variabel	Minimum	Maximum	Mean	Std. Deviation
ENV	.0000	1.0000	.5386	.2233
SOC	.1000	1.0000	.6287	.2080
GOV	.0000	1.0000	.8144	.3138
DAR	.1287	.8128	.4796	.1749
INST	.5246	.9927	.9116	.1042
ROA	.0022	.2426	.0653	.0426

The variables studied consist of Environmental Score (ENV), Social Score (SOC), Governance Score (GOV), Debt to Equity Ratio (DAR), Institutional Ownership (INST), and Return on Assets (ROA). Descriptive statistical analysis of 75 observations shows variations in the characteristics of each research variable. Regarding the Environmental Score (ENV), the variable recorded a minimum value of 0.00 and a maximum of 1.00, with a mean of 0.539 and a standard deviation of 0.223. These figures highlight that firms' environmental performance remains only moderate, reflecting uneven adoption of sustainability practices across companies. he Social Score (SOC) recorded an average of 0.629 with a standard deviation of 0.208, exceeding the ENV score and indicating stronger consistency in social responsibility compared to environmental performance. Meanwhile, the Governance Score (GOV) had the highest average, namely 0.814 with a range of 0.00 to 1.00 and a standard deviation of 0.314. This condition indicates that corporate governance in the research sample has generally been running well, although there are quite wide variations between companies.

The DAR variable averaged 0.480 with a standard deviation of 0.175, suggesting that around half of the capital structure is debt-financed and leverage remains moderate, though it varies among firms. The INST variable ranges between 0.525 and 0.993, with an average of 0.912 and a standard deviation of 0.104. This suggests that institutional investors dominate the ownership structure, thereby reinforcing managerial monitoring. The Return on Assets (ROA) variable has an average value of 0.065 with a standard deviation of 0.043. This shows that the profitability level of the sample companies is still relatively low, with the average ability of companies to generate profits only around 6.5% of their total assets.

In general, descriptive statistics show that corporate governance (GOV) and institutional ownership (INST) are relatively good, while profitability (ROA) is still low, and social performance (SOC) is more prominent than environmental performance (ENV).

Before testing the hypotheses, the model's feasibility was evaluated through classical assumption tests, namely normality, multicollinearity, heteroscedasticity, and autocorrelation. The One-Sample Kolmogorov-Smirnov test produced a significance score of 0.085, surpassing the 0.05 significance level. This finding indicates that the 75 observations meet the assumption of normality. The results of the multicollinearity test reveal tolerance values between 0.757 and 0.984 and VIF values ranging from 1.016 to 1.321. As these meet the established criteria (tolerance > 0.10; VIF <

10), the regression model can be considered free of multicollinearity. The heteroscedasticity test in this study employed the Glejser method. The analysis showed that all variables had significance values above 0.05, ranging from 0.060 to 0.892, indicating that the regression model is free from heteroscedasticity. The autocorrelation test shows a Durbin-Watson value of 1.998. The number of observations (n) is 75, with 5 independent variables (k). Thus, the Durbon Watson value that is satisfied is: DU<DW<4-DU (the DU value in this study is 1.7698). Therefore, the data in this study passes the autocorrelation test, with the following values: 1.7698<1.998<2.2302.

This research investigates the impact of ESG reporting on the financial performance of firms listed in the KEHATI Index. Table 2 shows the result of the regression analysis.

Table 2. Regression Result

Coefficients		***t - value***	***Sig.***
(Constant)	.165	4.126	.000
ENV	-.007	-.337	.737
SOC	-.035	-1.728	.089
GOV	.006	.472	.638
DAR	-.163	-7.480	.000
INST	-.001	-.016	.987
Adj. R square	.419		
F - value	11.655	.000	

Regression results show that the model accounts for 45.8% of the variation in ROA (R^2 = 0.458), with the rest explained by other factors. The F-test (sig. = 0.000 < 0.05) indicates that ENV, SOC, GOV, DAR, and INST jointly affect ROA. The ENV variable, however, has a negative but insignificant impact (β = -0.007; sig. 0.737), implying limited direct influence of environmental activities on profitability. This finding is in line with research stating that environmental responsibility practices often require large costs, so that the economic benefits are only visible in the long term. Social Score (SOC) also showed a negative but insignificant effect on ROA (β = -0.035; sig. 0.089).

This condition supports the view that corporate social activities do not always directly improve financial performance, as they are more oriented towards social legitimacy than short-term profits. These results are in line with studies that found a weak relationship between social performance and profitability in certain sectors. Score Governance (GOV) has a positive but insignificant coefficient on ROA (β = 0.006; sig. 0.638). This means that although corporate governance is important in maintaining transparency and accountability, in the context of this research sample, governance practices have not been able to directly increase profitability. This is similar to studies that emphasize that governance mechanisms play a greater role in reducing agency risk than in instantly boosting profitability.

The analysis reveals a significant negative relationship between DAR and ROA (β = -0.163; sig. 0.000). A larger proportion of debt in the capital structure diminishes profitability, consistent with trade-off theory, which emphasizes that excessive leverage increases interest obligations and bankruptcy risk. These findings are also corroborated by previous research documenting the detrimental impact of high leverage on firm performance.

Institutional ownership (INST) does not have a significant effect on ROA (β = -0.001; sig. 0.987). This indicates that high institutional ownership is not always followed by increased effective supervision of management, thereby failing to increase profitability. These results are consistent with studies that find that the effect of institutional ownership on financial performance

varies, depending on the context of the company and the effectiveness of the monitoring role of institutional investors.

The results of this study show that the Debt to Asset Ratio (DAR) has a significant negative effect on ROA. This finding is consistent with research by Kasasbeh (2021), who found that high leverage harms profitability because it increases interest expenses and financial risk. This supports the trade-off theory, which states that there are additional financial costs when companies are overly dependent on debt.

Meanwhile, the Environmental Score (ENV), Social Score (SOC), and Governance Score (GOV) variables did not show a significant effect on profitability. These results are in line with Sharma et al.'s (2022) study, which found that ESG disclosure has not been able to improve short-term financial performance, because the benefits of sustainability are more felt in the long term through reputation, legitimacy, and stakeholder trust. However, these results differ from the findings of, who stated that sustainability practices can have a positive impact on profitability in markets with high ESG awareness.

The institutional ownership variable (INST) does not have a significant effect on ROA. This is in line with Schwartz-Ziv & Schwartz-Ziv's (2021) research, which states that institutional investors do not necessarily perform their monitoring function effectively. However, this finding differs from the results of the study, which emphasize the important role of institutional ownership in improving the effectiveness of managerial oversight, thereby impacting financial performance.

CONCLUSIONS

The findings of this study indicate that the overall ESG reporting sections: environmental, social, and governance, do not have a significant direct effect on the financial performance of companies listed on the SRI-KEHATI Index. Specifically, neither environmental (ENV), social (SOC), nor governance (GOV) scores showed a statistically significant impact on Return on Assets (ROA). Additionally, control variables such as Debt to Asset Ratio (DAR) and Institutional Ownership (INST) also did not demonstrate a significant influence on financial outcomes within this sample.

This lack of significant relationship aligns with some previous research suggesting that ESG activities may not immediately or directly translate into financial gains, possibly due to the high costs and long-term nature of sustainability initiatives. Moreover, the variation in ESG performance among companies and their level of disclosure may also contribute to the inconclusive findings.

LIMITATIONS & FURTHER RESEARCH

For future research, it would be valuable to explore the long-term impacts of ESG performance on financial performance beyond the short-term horizon, possibly using a longitudinal approach. Additionally, expanding the sample size and including firms from different sectors or regions could provide more comprehensive insights. Further studies could also examine other financial performance metrics or incorporate qualitative aspects such as stakeholder perceptions to better understand the complex relationship between sustainability and profitability.

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