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The value relevance of esg rating: do investors care?

Aryo Bimo Setya Permana[1], Gery Utomo[2], Tuah Panjaitan[3]

[1] Department of Accounting, Al-Azhar University Medan, abimosetyap@gmail.com

[2] Department of Accounting, Al-Azhar University Medan, geryutomo0@gmail.com

[3] Department of Accounting, Al-Azhar University Medan, tuah919@gmail.com

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Abstract

This paper aims to investigate the value relevance of ESG Rating.. Using LQ45 IDX industry index, 27 firms for 2020 until 2022 period were collected as final sample. Ordinary least square regression analysis based on Ohlson price model was conducted. The result showed that ESG ratings does not have a value relevance, which means that investors particularly in Indonesian stock market still consider financial information such as profitability to make investment decision. Managerial implication such as allocating ESG resources can be useful to investor as they will consider ESG information on making investment decision.

INTRODUCTION

The need for environmental, social, and governance (ESG) information is essential to minimize information asymmetry between managers and stakeholders and to utilize this information in corporate decision-making (Koo & Kim, 2023). In general, sustainability reports primarily consist of qualitative information to reveal how ESG factors impact sustainable management. Companies voluntarily provide sustainability reports on their responses to climate change, activities to reduce carbon emissions, social investments in human resources, and corporate governance issues. The purpose of ESG is to develop socially responsible corporate values, balance competing economic and social interests, and allocate resources that facilitate diverse interests among involved parties in the company

(Tomo & Landi, 2016).

In Indonesia, the Financial Services Authority Regulation Number 51/POJK.03/2017 of 2017 explains the implementation of sustainable finance for financial institutions, issuers, and public companies. These regulations are in line with Indonesia's goal as a member of the United Nations (UN) in achieving the Sustainable Development Goals (SDGs) by 2030. Some companies are also aware of the significance of implementing ESG (kompas.com). Implementing SDGs indicates that sustainability issues are integrated into the strategic business plans of companies. On an operational scale, every organizational or corporate activity may face challenges related to sustainability, covering various aspects from technological innovation to changes in the corporate environment, as well as the role of the company in empowering the community.

Financial reporting is a foundation to assist investors in accounting information when choosing among the uses of scarce resources. As a result, accounting information should be useful in making a difference in investment decisions. Therefore, the relevance of value refers to the usefulness of accounting information and is defined as the ability of financial statements to influence stock prices (Francis & Schipper, 1999). In other words, the relevance of value tests the relationship between accounting information and stock market value (Badu & Appiah, 2018).

Several previous studies have been conducted to discuss the relevance of accounting or financial information. The research findings indicate that the explanatory power of accounting information has increased and become more beneficial for users in the capital market (Collins et al., 1997; Francis & Schipper, 1999). However, some studies have found different results, suggesting that accounting information has lost its relevance (Lev & Gu, 2016; Lev & Zarowin, 1999).

ESG role in value relevance is aiming to support companies that demonstrate strong ethical practices, responsible management, and a commitment to sustainable and socially responsible behavior. Investors incorporating ESG criteria into their decision-making process may choose to support companies that align with their values, believing that such companies are better positioned for long-term success and may face lower risks associated with environmental, social,

and governance issues (Koo & Kim, 2023).

There have been studies discussing ESG towards value relevance but they are also having mixed results. Koo & Kim (2023) found that ESG ratings increase Korean firm's value relevance in terms of development. Eng et al. (2022) ESG ratings in US firms can improve value relevance, because they provide incremental information content on market value and/or price (Aruning Puspita et al., 2023). In India, Maji & Lohia (2023) ESG scores are associated with firm's profitability. Different from these results, ESG also have no impact on value relevance (Ghazali & Zulmaita, 2020; Junius et al., 2020) Nirino et al. (2022) found that ESG has failed to maximize value relevance and Landi & Sciarelli (2019) that ESG has a negative impact on investment decision in Italian firms.

Legitimacy theory (Dowling & Pfeffer, 1975) suggests that organizations seek to maintain congruence with societal norms and values to ensure their continued legitimacy. By integrating legitimacy theory into ESG investing, companies are likely to focus not only on financial performance but also on aligning their activities with broader social and environmental expectations. This could enhance stakeholder perception, as companies are seen as not just profit-driven entities but as socially responsible actors (Eng et al., 2022). Investors may actively engage in practices that align with societal expectations. This lead to a shift in investor preferences towards companies perceived as more socially and environmentally responsible.

Based on gap and theory discussed above, this research aims to contribute to the ESG literature about its role in decision making, especially in stock market. Thus, we hypothesize:

H1: ESG rating has an influence on value relevance.

METHODS

The research design will adopts the price model developed by Ohlson (Ohlson, 1995). This model has been employed in previous value relevance studies (Badu & Appiah, 2018; Francis & Schipper, 1999) to examine the relevance of accounting information. The model will be slightly modified by incorporating ESG to meet the research question.

$$PRICE = \beta_0 + \beta_1 BVS + \beta_2 EPS + \beta_3 ESGR + e ....(1)$$

where *PRICE* is the end-year closing stock price, *BVS* is end-year book value at the period, *EPS* is earning per share at the period, and *ESGR* is ESG risk rating at the period from Morningstar Sustainalytics. They rate risk of material financial impacts or enterprise value driven by ESG factors. Morningstar Sustainalytics measured the ESG risk rating based on number which are 0-10 is "negligible", 10-2 is "low", 20-30 is "medium", 30-40 is "high", and above 40 is 'severe'. Data of these variables were obtained from annual LQ45 reports downloaded from Indonesia Stock Exchange (IDX) website.

Sample selection for this research includes companies listed on the LQ45 index of the Indonesia Stock Exchange (IDX). LQ45 comprises 45 companies with high market capitalization and liquidity, from 2020 until 2022. After eliminating a number of firms that have a negative EPS and not repeatedly featured in LQ45 index in 2020 until 2022, we have a total sample of 27 firms as shown in Table 1, thus the observation is 81.

Table 1. Sample selection

Criteria	**Number of samples**
Featured in LQ45 for consecutive three year (2020-2022)	29
Has a negative EPS	2
Final sample	**27**

RESULTS AND DISCUSSION

We begin this section with descriptive statistics and Pearson correlation of each and amongst variables.

Table 2. Descriptives and correlation

	Min	**Max**	**Mean**	**BV**	**EPS**	**ESGR**	**PRICE**
BV	105.00	26177.00	4423.2593	1	0.818*	0.181	0.819*
EPS	9.01	10561.25	618.1412	0.818*	1	0.193	0.778*
ESGR	17.56	62.02	33.2921	0.181	0.193	1	0.082
PRICE	466.00	39025.00	6754.4568	0.819*	0.778*	0.082	1

*) significant at 0.01 level

Based on table 2 above, ESG risk ratings, the focus of this research, has a mean number around 33.29. Therefore, LQ45 firms is considered to have high ESG risk, because majority of the firms have medium, high and severe ratings. As for correlation test, BV is correlated to EPS and PRICE ($p < 0.01$), EPS is correlated with BV and PRICE ($p < 0.01$), ESGR is not correlated with any of the variables ($p > 0.01$).

We continue to hypothesis testing. Ordinary least regression (OLS) was used to analyze the data using SPSS 21 software.

Table 3. Hypothesis test

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	4681.034	1775.184		2.637	.010
	BV	.747	.142	.559	5.269	.000
	EPS	1.777	.562	.337	3.165	.002
	ESG Risk	-69.958	51.926	-.084	-1.347	.182

Based on Table 3. BV and EPS have a positive and significant influence on PRICE (p-value 0,000 and 0,002 < 0.05) with coefficient of 0.747 and 1.777 respectively. These results align with previous studies (Badu & Appiah, 2018; Barth et al., 2023) that the ability of accounting information to provide explanations has grown, proving more advantageous for users in the financial markets. Meanwhile, ESGR does not have an influence toward PRICE with p-value 0.182 above 0.05. This result is align with previous studies (Ghazali & Zulmaita, 2020; Junius et al., 2020) that ESGR does not impact investor decision in capital market.

Many market participants are largely unaware of the actual impact of corporate ESG activities (Baboukardos, 2017). When information about a company's ESG activities, such as environmental, may incur costs. Shareholders reflexively perceive an increased risk associated with thecompany's environmental practices. This heightened risk perception leads to a reduction in shareholders' trust in the information regarding the company's ESG expenditures, ultimately

resulting in a decline in shareholder value. Therefore, ESG activities, such as climate change mitigation costs incurred by companies, may not be an appealing option for attracting stock market investors.

Previous research indicates that investors in the Indonesian stock market are still predominantly focused on maximizing profitability (Dewi & Adiwibowo, 2019; Imatul Khaira et al., 2019) as seen from the regression results. This focus is attributed to the fact that ESG activities in Indonesia, such as environmental protection programs, require resources that could be used for other purposes, such as identifying and funding investment opportunities that generate economic benefits (Liao et al., 2015). Companies, especially those with substantial ESG or CSR resources, often overlook returns in favor of contracts or social recognition, sacrificing profitable investment prospects for shareholders but causing harm to non-shareholders. Consequently, these activities of this nature can diminish the profitability of companies, particularly in the Indonesian stock market (Rukmana & Saputra, 2019).

This research has several managerial implications. First, firms engaging in ESG activities should focus on transparently communicating the actual impact of these initiatives. Clear and accurate communication can help mitigate the reflexive risk perception by shareholders, fostering trust in the company's ESG-related information. Second, managers need to strike a balance between ESG initiatives and profitability considerations. While ESG activities are crucial for social and environmental responsibility, companies should be mindful of the potential costs and risks associated with these initiatives, ensuring they do not adversely affect shareholder value. Lastly, efficient resource allocation is vital. Firms should carefully allocate resources for ESG activities, considering the potential trade-offs between these initiatives and other investment opportunities. Strategic planning can help maximize economic benefits while addressing environmental and social concerns.

Policymakers also play a crucial role in establishing clear and supportive regulatory frameworks that encourage responsible corporate behavior. Regulations should provide incentives for companies to integrate ESG considerations without compromising financial viability, so that investors can seek a better understanding of the long-term benefits and risks associated with ESG activities. Making informed investment decisions involves considering not

only short-term financial returns but also the sustainability and societal impact of the firms in their portfolios.

CONCLUSION

Results indicates that ESG ratings have no impact on value relevance, which means that investors do not consider ESG information as part of their investing decision. In summary, the research highlights the challenge of limited awareness among market participants about the actual impact of corporate ESG activities, leading to a reflexive perception of increased risk by shareholders and a subsequent decline in trust and shareholder value. Particularly in the Indonesian stock market, where investors predominantly focus on maximizing profitability, ESG activities face hurdles in attracting investors due to resource competition with economically beneficial opportunities. The managerial implications emphasize the need for transparent communication, balancing ESG initiatives with profitability considerations, and efficient resource allocation. Policymakers play a crucial role in incentivizing responsible corporate behavior through supportive regulatory frameworks. Ultimately, informed investment decisions require a comprehensive assessment, considering both short-term financial returns and the long-term sustainability and societal impact of firms in investors' portfolios.

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