CHAPTER I

RESEARCH BACKGROUND

A. Research Background

In 2020, the entire country experienced the tragedy of COVID-19, which paralyzed all societal activities. The COVID-19 pandemic has sparked crises worldwide, affecting not only health but also extending to social and economic crises, including the financial sector (Kemenkeu, 2020). The regulatory authority overseeing the financial sector, the Financial Services Authority (OJK), stated that the COVID-19 pandemic has dealt a severe blow, including to the Composite Stock Price Index (IHSG). As reported by Bank Indonesia (2022), there was a recorded decrease in transaction volume from 36,534,971,048 in 2019 to 27,495,947,445 in 2020. This decline in transaction volume signifies the deteriorating situation in Indonesia, which has affected the capital market. The decrease in transaction volume can trigger significant impacts on companies' financial performance. Therefore, many companies and stakeholders are beginning to pay attention to factors beyond financial aspects, such as Environmental, Social, Governance (ESG) management (Hwang et al., 2021).

In the environmental sector, the impact of the COVID-19 pandemic on companies cannot be overlooked. Reductions, restrictions, and changes in activities have led to significant alterations in the dynamics of the surrounding environment. Additionally, declines in human mobility and vehicle usage have resulted in decreased air pollution and reduced plastic waste due to decreased consumer product usage. However, companies must also consider negative impacts, such as increased medical waste and the use of disposable products in pandemic management. In this regard, companies with strong environmental performance will mitigate social impacts occurring in communities, thereby increasing public trust in the company and potentially generating financial benefits (Rahmawati & Achmad, 2012).

Xu and Zhang (2022) emphasized that the implementation of regulations and systems aligned with environmental protection in production and operational processes can impact enterprise operations and effectively enhance income levels while expanding investments in environmental protection. Companies that fail to account for the environmental impacts of their operations may face pressure from customers, investors, or regulations, which could negatively affect their financial performance. Moreover, in managing the environment and addressing its impacts on the surrounding ecosystem, environmental costs are inevitably incurred. Allocating expenditure dedicated to environmental management demonstrates a company's consistency in environmental stewardship, thereby building trust among the public regarding corporate social responsibility (Tunggal & Fachrurrozie, 2014). Therefore, companies must consider and address the implications of environmental factors and adjust business strategies accordingly to play a pivotal role in supporting business growth and maintaining financial performance amid the challenges posed by the COVID-19 pandemic.

In the social sector, the phenomenon of COVID-19 has triggered the implementation of various government policies that must be adhered to by the public to curb the growth of the number of patients, initially in the form of Large- Scale Social Restrictions (PSBB), which later transformed into the Enforcement of Restrictions on Community Activities (PPKM). This has altered the pattern of societal interactions in carrying out daily activities, such as the implementation of Work from Home for employees, the transition to online learning activities, restrictions on public transportation, limitations on religious activities, and other events. With the limitations on mobility experienced by the public, it necessitated active engagement in using online systems. This includes online business activities and investments in the capital market, which were affected by the pandemic, causing difficulties for companies to sustain themselves during that time.

The high disclosure of social performance leads to an increase in the financial performance of companies. This is attributed to the significant level of trust from the public and consumers towards the company, which in turn fosters greater employee loyalty and morale due to its strong social performance (Inawati & Rahmawati, 2023). However, in facing the challenges brought about by the COVID-19 pandemic, a company may find itself trapped in situations requiring difficult policy decisions. On the other hand, Liu et al. (2022) say that businesses under more pressure are likely to perform better in non-financial areas, resulting into better financial outcomes. Similarly, Qiu et al. (2021) state that a firm's contribution to social activities drives an increase in the firm's marketreputation and financial performance during economic crises such as COVID-19. Considering the uncertain economic factors and the direct impact of revenue decline, companies must take drastic measures to maintain financial stability. By taking such measures, companies aim to preserve financial stability while striving to minimize the social impact of decisions made during the COVID-19 pandemic.

Within the governance pillar, there exists a distinct case regarding the financial reporting of PT Garuda Indonesia, which has entered an endless labyrinth. Arguments, both for and against, as well as audit results from various capital market supervisory bodies such as the Financial Services Authority (OJK) and the Indonesia Stock Exchange (IDX), have shed light on the accuracy of the company's financial reports. As reported by the Consumer News and Business Channel Indonesia (CNBC) (2022), a financial reporting scandal occurred at PT Garuda Indonesia, wherein the company stated a net profit of USD 890.85 million in 2019. Although the financial report recorded a high net profit, it was rejected by two commissioners due to irregularities in revenue recognition stemming from a partnership with PT Mahata Aero Teknologi. This scandal has had serious repercussions on the reputation and trust of the public in PT Garuda Indonesia. The financial report of PT Garuda Indonesia for the year 2019 recorded a profit, whereas previously the company had incurred losses. Audits conducted by various capital market supervisory bodies and requests for the re- presentation of financial reports have become the focal points concerning the financial performance of the company.

This case underscores the importance of transparency and compliance with accounting standards in presenting a company's financial statements. Companies with good governance practices, which include management evaluation and transparency in all reporting activities, can make informed business decisions to meet the financial performance targets of the company (Minggu et al., 2023). This aligns with the statement by Ratmono and Sagala (2015), who assert that companies with transparent financial statements and compliance with accounting standards are accepted by society and strengthen their legitimacy. This also reflects how a company's financial performance can influence its reputation, public trust, and interventions by capital market supervisory institutions, ultimately impacting the company's value and relationships with stakeholders.

Therefore, it is undeniable that the financial performance of a company serves as the primary matrix in assessing the level of success of a company. Visualizing financial performance provides an overview of the activities conducted by a company to achieve its business objectives over a specific period (Putra et al., 2021). The better the financial performance of a company, the higher its level of success. This can directly impact the financial health and stability of the company, thus affecting shareholders and stakeholders. It is also stipulated in Government Regulation No. 29 of 2014 concerning the Performance Accounting System of Government Agencies, and Minister of State Apparatus Empowerment and Bureaucratic Reform Regulation No. 53 of 2014 that every government agency is required to prepare Performance Reports as a form of accountability for achieving the strategic goals/targets of the agency (BPPK, 2023). The Performance Report must be presented systematically and measurably to provide transparent information about the performance of each agency and its achievements. Additionally, the financial performance of a company has broader impacts on the overall economy, thus affecting people's livelihoods (ÖZER et al., 2023). The success of financial performance reflects the success of a company, which can influence a country's Gross National Product (GNP) and Gross Domestic Product (GDP). This occurs because the success of a company can significantly contribute to the country's economy, such as increased company profits, business expansion, and job creation.

Company performance is one of the crucial indicators for both the company itself and its stakeholders. Performance reflects a company's ability to manage or utilize its resources effectively. It is an outcome achieved through various activities conducted with the utilization of available resources. Financial performance, literally speaking, can be influenced by and/or measured through several factors. According to Horngren et al. (2009), performance measurement can be categorized into financial performance measurement and non-financial performance measurement. Financial performance encompasses several indicators such as profitability, solvency, liquidity, and others. Additionally, there are non-financial performance indicators such as the implementation of Environmental, Social, and Governance (ESG) practices, which have a broader scope. In this research, the focus will be on calculating financial performance using profitability ratios influenced by ESG activities.

ESG (Environmental, Social, and Governance) is a concept that prioritizes sustainable business, development, and investment. ESG has emerged as a crucial pillar of CSR (Corporate Social Responsibility) for developing sustainable strategies that influence financial performance (Duque-Grisales & Aguilera-Caracuel, 2021). ESG provides a more comprehensive and measurable approach to evaluating a company's sustainability performance. In contrast, CSR often focuses on voluntary social initiatives by companies and tends to be more philanthropic in nature. Therefore, the use of ESG in this research enables a deeper and more objective analysis of a company's sustainability performance. ESG focuses on taking steps further with proper measurement and assessment. With the development of a country's economy due to the influence of a company's financial performance or activities on the environment, society, governance, and the application of Islamic values such as striving, mutual assistance, and helping one another, individuals and groups are instructed to preserve the environment that has been created and help fellow Muslims, factors considered in financial performance. As Allah says in Surah Al-A’raf/7:36:,

وَلَا تُفْسِدُوْا فِى الْاَرْضِ بَعْدَ اِصْلَاحِهَا وَادْعُوْهُ خَوْفًا وَّطَمَعًاۗ
اِنَّ رَحْمَتَ اللّٰهِ قَرِيْبٌ مِّنَ الْمُحْسِنِيْنَ ٥٦

The meaning : “ Do not spread corruption in the land after it has been set in order. And call upon Him with hope and fear. Indeed, Allah’s mercy is always close to the good-doers.”

Based on those cases, the author aims to investigate several company variables that may influence financial performance, namely environment, social, and governance (ESG), moderated by Financial Slack.

Optimizing firm value for all stakeholders requires preserving a company's long-term sustainability under corporate governance. (Zahroh & Hersugondo, 2021). This is especially relevant for companies closely associated with Environmental, Social, and Governance (ESG) factors such as manufacturing companies. Additionally, the implementation of ESG practices can attract investors in making investment decisions in socially responsible companies (Zahroh & Hersugondo, 2021). Inawati and Rahmawati (2023) also argue that sustainable development initiatives tend to be attractive to prospective investors, necessitating resource allocation and greater financial resources for environmental, social, and governance (ESG) performance. This is because the world economy is deeply interconnected with trade and investment, making issues related to company disclosures to stakeholders a crucial consideration (Buallay, 2019). Furthermore, according to (Hassani & Bahini, 2022), investors, lenders, and other stakeholders worldwide increasingly incorporating environmental, social, and governance factors into their business decisions.

There is still considerable debate regarding the importance and necessity of companies implementing Environment, Social, and Governance (ESG) practices. This is due to the perception that the success rate of companies implementing ESG tends to be overlooked. Singh et al. (2023) argue that the implementation or investment of a company in ESG activities does not significantly impact the financial performance of a company. This is also supported by Dragomir (2020), who suggests that ESG implementation does not fully demonstrate profit implications on financial performance but rather influences the company's value with non-financial goals that may lead to less effective company performance. However, despite these arguments, there is still literature indicating that ESG implementation can indeed affect a company.

This study is an extension of the research conducted by Duque-Grisales and Aguilera-Caracuel (2021). The previous study had independent variables, namely ESG scores, and a dependent variable, financial performance, moderated by the effects of geographic international diversification and financial slack. The difference between this study and the previous one is that the researcher aims to focus on the influence of the implementation of each sub-category of ESG, namely Environmental, Social, and Governance, on Financial Performance moderated by Financial Slack. In this study, the researcher does not re-discuss The Effect of geographic international diversification because the focus is on delving deeper into and focusing on the relationship between each pillar and financial performance, as well as the influence of financial slack on the relationship between these variables. Additionally, this study has a different object compared to the previous one, which focused on multinational companies in Latin America. Instead, this study focuses more on manufacturing companies in Indonesia listed on the Indonesia Stock Exchange (IDX) from 2021 to 2023. Furthermore, this study uses the same moderating variable as the previous study, which is Financial Slack.

Based on the inconsistent research findings, the author intends to conduct further research on the influence of Environmental, Social, and Governance factors on Financial Performance, moderated by Financial

Slack.

B. Research Problem Limitation

The scope of this research is limited to focusing solely on Indonesian manufacturing companies listed on the Indonesia Stock Exchange (IDX) from 2021 to 2023.

C. Research Problems Formulation

Based on the background of the problem described above, the following problem formulation can be formulated:

1. Does enviromental factor have a positive effect on financial performance?
2. Does social factor have a positive effect on financial performance?
3. Does governance factor have a positive effect on financial performance?
4. Does ESG Disclosure have a positive effect on financial performance?
5. Does financial slack moderate the relationship between environmental aspect and financial performance?
6. Does financial slack moderate the relationship between social aspect and financial performance?
7. Does financial slack moderate the relationship between governance aspect and financial performance?
8. Does financial slack moderate the relationship between ESG disclosure and financial performance?

D. Research Objectives

The purposes of this research are :

1. To empirically test the effect of environmental aspect on financial performance
2. To empirically test the effect of social aspect on financial performance
3. To empirically test the effect of governance aspect on financial performance
4. To empirically test the effect of ESG disclosure on financial performance
5. To empirically test the effect of environmental aspect on financial performance through the moderating variable of financial slack.
6. To empirically test the effect of social aspect on financial performance through the moderating variable of financial slack.
7. To empirically test the effect of governance aspect on financial performance through the moderating variable of financial slack.
8. To empirically test the effect of ESG disclosure on financial performance through the moderating variable of financial slack

E. Research Benefits

The benefits that researchers expect from this research as follows:

1. Theoretical Benefits

This research examines and produces relationships between variables that are included with an understanding of the basic concepts of variables, research directions, and research framework so that it can contribute to the development of knowledge for parties who need this research as a form of support in encouraging thinking to be more critical. Further it can be one of the literature studies that looks at the level of consistency or not in research results related to company components that can influence the quality of financial reports.

2. Practical Benefits

a) For the Companies

This research can provide an overview for related companies and other interested parties regarding indicators that can be considered, as well as the measurement methods and processes of a company's components. This can serve as a reference to enhance the quality of financial reports, ultimately benefiting both internal and external stakeholders of the company.

b) For the Future Researcher

In addition, this research is also expected to provide new insights into the impact of the Company's components on financial performance, which can serve as a reference for future research