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The Effect Of Environmental, Social and Governance (ESG) Disclosure on Firm Performance: The Role of Ceo Tenure

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ABSTRACT

This paper aims to investigate the effect of environmental, social, and governance (ESG) disclosure on firm performance, which is measured by ROE. We also analyze the role of CEO tenure on the relationship between ESG disclosure and ROE. We used 159 samples of public listed companies in Indonesia during period of 2012 to 2016. We employed multiple regression technique to assess the research model. The findings show that ESG disclosure has a positive impact on ROE. The better the quality of ESG disclosure can enhance the level of ROE. In addition, we found a moderating effect of CEO tenure on the relationship between ESG disclosure and ROE. However, CEO tenure plays a role in decreasing the relationship between ESG disclosure and ROE. Our empirical evidence support the process of sustainability investment by using ESG data analysis, to get more comprehensive picture regarding companies sustainability performance. The findings of this study are expected to provide strong evidence regarding the importance of ESG disclosure in enhancing corporate performance. Furthermore, the findings are also expected to be able to ensure potential investors in using ESG disclosure to evaluate corporate sustainability performance.

KEYWORDS: CEO Tenure, ESG Disclosure; Financial Performance; Sustainability Performance; Sustainability Reporting

INTRODUCTION

Firm performance is very important for stakeholders. Firms that do business usually make profit the firm's main goal. Companies are more trying to maximize profits and ignore the factors of human relations among workers, environment and surrounding communities. Business operations run by the company will have an impact on the company's environment. Business activities that do not focus on company's sustainability will thread the environment.

Industry is a sector that is very important in improving the national economy. In this industrial activity is a concern when the industrial sector is not responsive to the surrounding environment that results in poor environmental quality in the area of the company. The impact of environmental damage is a very serious problem that needs to be followed up on by the company as a form of responsibility for the company's activities. The cause of environmental damage is due to the use of natural resources that are not in accordance with the usage procedures. The company is only concerned with the interests of the company to maximize economic profits without regard to the surrounding environment.

Syafrullah & Muharam (2017) stated that companies must pay attention to the environmental conditions in which the company carries out its operational activities. If the company gets good value in terms of environmental stewardship, the company's survival will also be better. The survival of the company does not depend solely on improving the company's performance but also on the attention of all company stakeholders including the environment. CEO's decision on social disclosure does not only focus on investment as an effort to increase the value of the company, but also as the company's interaction with the environment (Hui & Matsunaga, 2015).

Putra & Utama (2015) stated that social performance has a positive effect on the company's financial performance. High corporate social responsibility will attract investors to invest the capital to the company. Companies should look at CSR as a way of planning a company's business. This can be done by balancing the company's CSR program with the company's image it self. Good governance has been shown to increase investor confidence which results in increased company value. It is hoped that governance can provide direction for stakeholders in building a framework for implementing good governance. For entrepreneurs, this basis is usually used as a direction to increase the added value and sustainability of a business.

Profitability is a factor of management performance to process the company's assets. Return On Equity (ROE) is a measure of profitability based on the company's ability to generate profits at a certain level of share capital. The profitability and disclosure relationship is a social response so that the company can operate, meaning that the company will disclose more information if the ability to generate high profits so that investors and creditors believe the company is in a safe position and the company's activities operate efficiently.

Budiharjo (2016) stated that the significant positive effect between GCG and stock returns through profitability ratios. Companies with good corporate governance concepts and have high profitability will be able to show a high stock return for the company. Atan *et al.* (2018) found that there is no significant association between individual factors and the combined ESG and company profitability namely, ROE. The company requires special attention to the environmental conditions in which the company carries out its activities.

This study aims to investigate whether CEO's tenure plays a moderating role on the relationship between ESG disclosure and firm's performance. As CEO is the most important person in corporate management, he has a considerable control on strategic decisions (Velte, 2019). An experienced CEO can influence the decision-making process within company, especially on the stakeholder's interests. The prior studies have not indicated yet clearly, whether the CEO's tenure may strengthen the process of ESG reporting. Therefore, this is will be our focused on this study.

We found that ESG disclosure influence firm's performance strongly, while CEO's tenure weaken the effect of ESG disclosure on firm's performance. From theoretical perspective, our findings give a strong evidence on the importance of information transparency, especially companies sustainability's aspects. Company want to disclose information voluntarily, because it has an effect on investor's confidence and also can enhance financial performance. On practical perspective, our findings support the process of regulation in mandatory sustainability reporting and provide a clear information on the importance of incorporating non-financial aspects into investment data analysis.

In stakeholder theory and legitimacy theory perspectives, a company's organization needs to pay attention to the values and norms that exist in the community where the company's activities are running in order to produce legitimacy from the surrounding community and provide benefits to its stakeholders. This is important because community recognition is used as a factor that can affect the company's sustainability. Disclosures can be used to explain changes in ESG policies or to improve a company's poor reputation for performing company performance. The survival of a company depends not only on improving the company's financial performance but on the attention of all stakeholders including the environment around the company. The company must also have a good impact on all stakeholders because stakeholder's confidence in investment will increase the company's capital. This is in line with the legitimacy and stakeholder theories perspectives because companies consider good governance in order to gain community legitimacy.

The most important objective of stakeholder theory and legitimacy theory is assisting manager to understand the stakeholder environment and to manage effectively among the relationships around the companies's environment (Atan *et al.*, 2018). Both stakeholder theory and legitimacy theory can be used to explain why an entity choose to make voluntary disclosures, organizational legitimacy and company disclosures in annual reports as a strategy to maintain the sustainability of the organization. Syafrullah & Muharam (2017) said that legitimacy theory depends on the premise of a social contract between the company and the surrounding community. A social contract is a way for a company to have high expectations from the community on how the company conducts its business. This requires a company's response to care about the environment in which the company runs its operations. Social contract is a matter in the theory of legitimacy between the company and the community in which the company does business. The company will operate in an external environment that changes significantly and has confidence that the company's behavior is in accordance with the norms prevailing in the surrounding community.

This study intends to re-examine the effect of ESG disclosure on firm performance by analyzing the role of CEO tenure. ESG disclosure itself is a form of strategic tool which can be used to gain legitimacy through corporate social responsibility aspect. Based on the stakeholder theory approach, ESG disclosure is one of business policy that can influence stakeholder outside the firm. The influence may in the forms of the increased of investors'

confidence (Zuraida et al., 2016), the increased of share price and stock return (Setyahuni & Handayani, 2020) and signal of corporate's management improvement (Faisal et al., 2018). The greater the level of stakeholder's trust to the company, the better the resources that will be got by the company. Therefore, information transparency on business activity will have a direct influence on company's financial performance.

ESG disclosure is the newest form of the development of voluntary information reporting, which are begun by standalone CSR reporting, sustainability reporting and then followed by integrated reporting (Faisal et al., 2018). ESG measure corporate sustainability information in a comprehensive way. There are three aspects in ESG score, namely : environmental, social, and governance in a single score. Each aspect have its own indicators to assess the corporate sustainability performance. By using a new measurement that have incorporated three aspects of corporate social responsibility, ESG score is able to be used by investors as a tool to evaluate corporate sustainability performance more comprehensively (Zuraida et al., 2016).

Most scholars have investigated the effect of ESG disclosure on company performance. The results, however, still indicate an inconclusiveness. Orlitzky *et al.* (2003) found a positive influence between Corporate Social Performance (CSP) on Return on Assets (ROA) and Return on Equity (ROE) of the company. Fatemi *et al.* (2018) examined the effect of ESG on financial performance. The results of the study showed a negative relationship. This result differs from (Atan *et al.*, 2018), who found a positive effect of ESG on firm value. Faisal (2018) found evidence that ESG Disclosure has no impact on corporate performance. According to Budiharjo (2016) a company that applied the concept of good governance and has a high ROA level will increase the company's stock returns. Therefore, the better the quality of ESG disclosure, the higher the financial performance of the company. Based on the reason explained, therefore, the first hypothesis is proposed as follows :

H₁ : ESG disclosure has a positive effect on firm performance.

The existence of an effective board of directors in implementing corporate governance is very important (Fuente *et al.*, 2017 ; Ibrahim & Hanefah, 2016). According to Li *et al.* (2018) higher CEO power can improve the effect of ESG disclosure on firm performance. The greater the power of CEO, the better commitment of the company to improve ESG practice. ESG information that is disclosed by the company is influenced by the interactions CEO power so that it will produce a high firm performance. Another study, (Hui & Matsunaga, 2015) found that in making social disclosure decisions, the CEO not only focused on investment as an effort to increase the value of the company but also as the company's interaction with the environment. As the core of the executive team, the CEO is expected to be a key determinant for overcoming institutional pressures related to corporate environmental policies. We use different proxy to measure CEO power. We measured CEO power by using CEO tenure rather than CEO payment, as used by (Li *et al.*, 2018). The use of CEO payment may lead to bias interpretation due to company's characteristics. The bigger the company size, the higher the payment that can received by the CEO. On the other hand, CEO's skills and abilities increase in accordance with the work experience. The longer the CEO tenure, the greater CEO's abilities to make strategy regarding ESG practice, which can increase firm performance.

F. Li *et al.* (2016) stated that Chief Executive Officer (CEO) is the highest position in a company. The CEO comes from international standards and in Indonesia as the main director, namely the highest executive level who has full responsibility for all company

activities. Investors can find out if a company is developing or not by looking at the CEO of a company. The CEO is expected to make big decisions related to the company's social performance. Investors will consider investing in the company if investors believe the CEO leadership to develop companies that benefit the company. Supporting this argument, (Setiawan *et al.*, 2018) found that CEO tenure has a positive impact on CSR disclosure. The longer the CEO tenure, the better the disclosure of CSR. On the other hand, (Zhuang *et al.*, 2018) argued that long CEO tenure will lead managers becoming unresponsive to the newest developments. They found a negative impact of CEO tenure on CSR disclosure. Mitchell & Wood (2017) stated that CEO is a determining factor for the management stakeholders. The CEO who has the more power of direct control over the company's operations will show more performance on environmental policy issues in terms of ESG disclosure, hence, it can improve company performance. Based on the theoretical reviews, thus, the second hypothesis is proposed as follows :

H₂ : The CEO tenure plays a moderating role in the relationship between ESG disclosure and firm performance

METHOD

The population of this study were 467 public listed companies in Indonesia during 2012-2016. 2012 was the period of the start of the implementation of social and environmental responsibility obligation for public companies in Indonesia. This obligation was strengthened by the issuance of Government Regulation Number 47 of 2012 concerning Social and Environmental Responsibility of Public Limited Companies (Adhari & D., 2015). The ESG disclosure data were vary by year to year. We found that ESG disclosure after 2016 were very limited due to voluntary characteristic, which have no requirement to disclose it timely. Therefore, we used the ESG data up to 2016. Sample was selected using purposive technique based on the data availability. Companies which did not disclose ESG information would not selected as a sample. The final sample of this study was 32 companies, forming 159 firm-year observations.

Operational Definition and Variable Measurement

ROE is measured by net income deflated by the number of total equity at the end of fiscal year. ESG disclosure is measured by using Bloomberg score, which is run from 0 per cent to 100 per cent. The higher the score level, the better the quality and quantity of ESG disclosure. There are 120 different points for Bloomberg ESG indicators, which are 60 points are for environmental disclosure, 26 points are for social indicators, and 34 points are for governance indicators. Bloomberg ESG scores represent transparency, risk, and profitability (Faisal, 2018). CEO tenure is measured by the number of work experience of CEO in unit of month (Sudana & Aristina, 2017).

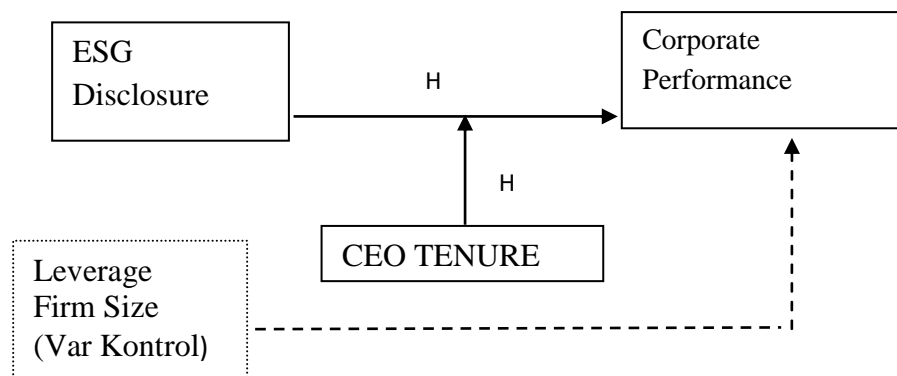


Figure 1.
Research Model

Several control variables i.e., leverage and firm size, were employed to control the effect of other variables, which not be focus of the research, but they were expected to have an impact on dependent variable. Leverage performs a business risk that may influence the future financial performance (Atan et al., 2018; F. Li et al., 2016). Firm size is expected to have an impact on ESG disclosure (Atan et al., 2018; Velte, 2019). The larger the firm size, the greater the level of ESG disclosure because company have greater resources to disclose the information. We measured leverage by Debt to Equity Ratio (DER), while firm size is measured by the number of natural logarithm of total asset.

Data Analysis Technique

We used multiple regressions analysis to test the hypotheses. SPSS 24 is applied as a statistics software. We have ESG disclosure as independent variable, while ROE is a dependent variable. We analyzed the effect of ESG disclosure and CEO tenure’s interaction on ROE. We also employ several control variables i.e. leverage and firm size. Following model is written as follows :

$$ROE_{it} = a + \beta_1 ESG_{it} + \beta_2 tenure_{it} + \beta_3 ESG_{it} \times Tenure_{it} + \beta_4 Leverage_{it} + \beta_4 Firm Size_{it} + \varepsilon_{it} \dots (1)$$

RESULTS AND DISCUSSION

Descriptive Statistics

Table 1 presents the descriptive statistics of 159 firm-year observations. On average, ROE of all companies is 21.73%, while the minimum ROE is -36.37%, and the maximum is 134.09%, which is categorized as a low score. Meanwhile, the average of ESG disclosure is 18.41%, the minimum score is 1.45%, while the maximum score is 69.87%. The number of ESG disclosure can be considered as high score because in Indonesia, ESG is still voluntary reporting, hence there is no regulation that require company to disclose the information in a certain level. In addition, all data show a wide range of data distribution due to the number of variable averages are less than its standar deviation.

Variables	Minimum	Maximum	Mean	Standar Deviation
ROE	-36.37	134.09	21.73	22.78
ESG	1.45	69.87	18.41	12.30
TENURE	1.00	141.00	47.99	31.63
SIZE	5.64	435.47	21.44	65.97
LEV	0.00	46.84	16.16	12.08
ESG x TENURE	2.86	8.87	6.31	1.07

Table 1.
Descriptive
Statistics

Regression Results

Table 2 provides the results of regression analysis. SPSS 24 is used to examine the regression models. Before we run for regression test, we examine the classical assumption test first, in order to get the best linear unbiased estimator (BLUE). All the variables have no problem with the classical assumption.

The empirical evidence supported hypothesis 1 strongly (0.000, p<0.05). We found a positive effect of ESG disclosure on ROE. This finding proved that companies that have a better information of ESG got a better ROE performance than those who disclose less information on ESG. It means that companies with higher ESG disclosures will result in

higher profitability. Companies that apply the concept of GCG and have a high ROE level will be able to increase the company's stock return, hence will increase firm value.

Variables	Coefficient	t	Sig Level	Adj R ²
(Constant)	39,502	4,085	,000*	
ESG	1,918	17,208	,000*	
TENURE	,286	4,559	,000*	0.713
SIZE	,034	2,248	,026*	
LEV	-,083	-,989	,324	
ESG x TENURE	-10,487	-5,065	,000*	

Note : *significant at 0.05 level

Table 2.
Regression
Results

If the company get a good value in the aspect of environmental performance, the company will be able to maintain its long-term sustainability, because the company gained legitimacy in the society where the company take place. This finding is supported the research conducted by Budiharjo (2016), Al-Tuwaijri *et al.* (2004) that found a positive impact of ESG disclosure on firm performance. This result is different from the research conducted by Atan *et al.* (2018) that found no significant relationship between ESG disclosure factors and ROE.

Our first finding is in line with stakeholder theory. Company will gain legitimacy from society if it consider both norms and regulation within society. In addition, company also have social responsibility, as a part of social order. Stakeholder theory states that company which operate its business activities must give a positive impact not only to owner, but also to all stakeholders, both inside and outside the company. ESG disclosure become one of tools to maintain a good relationship among all stakeholders widely. ESG accommodate the social responsibility aspects such as customers, employees, stockholders, suppliers, and wider societies.

Our empirical evidence supports hypothesis 2 strongly. The significance level of coefficient. From the regression result, we can infer that the CEO tenure plays a moderation role on the relationship between ESG disclosure and ROE. This evidence proved the longer the CEO's tenure will decrease the level of ESG disclosure. CEO tenure weaken the ESG disclosure and ROE's relationship. CEO usually start to handle major responsibility on various decisions in their second or third year on their work (Shen, 2003), while reshaping organization and selecting best strategy are become their main focus. In that process, CEOs maintain to improve their capability though their work experience. In contrast, after CEO has shown their capability in maintaining firm performance, their position will become secure and acceptable to the shareholders. It was caused by the CEO's power which has been instutualized and taken for granted. According to Setiawan *et al.* (2018), the longer CEO tenure, the greater value added that can be contributed to the company.

According to stakeholder theory and legitimacy theory, an organization need to pay attention on values and norms which are believed by societies, to be legitimate and accepted. Legitimacy is an important aspect because it can influence company's sustainability. To gain legitimacy, company need to make an effort to clarify that its business activies have been represented the social norms, hence the company performance can be improved. In this context, CEO plays an important role to make startegic decision regarding company's sustaianbility performance. However, the improvement of CEO's capacity does not mean that it can improve ESG disclosure, which can be a tool to gain

legitimacy. It because his capability and his power has been institutionalized and acceptable among stakeholders widely.

This finding supported McCarthy *et al.* (2017) and Setiawan *et al.* (2018), who found a positive impact of CEO tenure on CSR disclosure. It was because CEO who have a longer tenure, have a better understanding on company activities, hence they can make a better strategic decision regarding corporate sustainability than they who have a shorter tenure. Conversely, shorter CEO tenure acquire the greater level of supervision from the board of directors or stakeholders. Generally, it takes more than two years for new CEOs to acquire knowledge before they proceed the main action to transform their organization. The long CEO tenure will be able to reduce the relationship between ESG disclosure and firm performance. The long CEO tenure, however, is associated with the high level of CEO's professionalism and expertise, resulting the increase of CEO power to influence managerial decisions. Meanwhile, The level of CEO's competence is also a form of capital that can be used by firm to legitimate their activities in society, in order to maintain long-term company's sustainability.

Control variables which is significant at 0.05 level is only firm size. This result indicates that the higher firm size, the higher resources that companies can use to improve the quality of ESG disclosure, and they may have an influence on corporate's performance. Leverage, on the other hand, has p value > 0.05, therefore it does not have an influence on firm performance. The higher level of firm's leverage can not assure the quality of ESG disclosure, hence, its impact on firm performance can not be determined.

CONCLUSION

This study aims to investigate the effect of ESG disclosure on firm performance, which is measured by ROE, and the role of CEO tenure on the relationship between ESG disclosure and ROE. The empirical evidence show that ESG disclosure has a positive impact on firm performance. Companies which have a good environmental performance will gain a high level of ROE and resulting the increase of firms value. In addition, CEO tenure weakens the relationship between ESG disclosure and ROE. This evidence indicates that CEO tenure has a moderation role on the relationship between ESG disclosure and ROE. Investors do not pay consider CEO's role to determine its influence in environmental information and the expected rate of return obtained from investments, when investors want to make decision whether a project is profitable or not.

Our findings have impacts both theoretically and practically. From theoretical perspective, our results support the importance of information transparency regarding sustainability reporting. Information disclosure is important to increase stakeholder's confidence. Meanwhile, on practical perspective, our findings support the regulation process of sustainability reporting in Indonesia, by giving evidence regarding the importance of ESG disclosure and its effect on financial performance. Second, from investors perspective, our empirical evidence can support the incorporating of ESG data into investment analysis model, to get a more comprehensive picture of the sustainability aspects of firm performance.

Our study, however, has several limitations. First, our research only focus on the public listed companies in Indonesia during five years period. A larger sample and cross country analysis are needed to get more convincing evidence regarding the effect of ESG disclosure on financial performance. Second, we only focus on aggregate analysis of ESG factors to examine its impact on financial performance.

According to *Zuraida et al.*, (2016), the use of cumulative aspect of ESG factors may lead to bias interpretation due to the coverage of its component on financial performance. Therefore, it may become a challenge for upcoming research to examine the effect of ESG factors individually.

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