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# Does ESG Risk Rating Matter for Firm Value in Indonesia? Testing the Interaction Effect of Firm Size

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***Abstract***

*This study aims to analyze the impact of ESG Risk Rating, profitability, and growth opportunity on firm value. Given the ongoing debates surrounding ESG research in Indonesia, a more in-depth examination is required. The researcher has developed three econometric models to test six hypotheses related to this issue. This research is distinct from previous studies as it proposes an integrated model incorporating firm size as a moderating variable. The estimation model was tested using moderated regression analysis (MRA), with data comprising 240 observations over the period 2019-2024. The analysis results indicate that ESG Risk Rating in Indonesia does not have a significant impact on firm value. However, profitability and growth opportunity exhibit a significant positive effect on firm value. Further, the interaction model analysis reveals that firm size moderates the relationship between growth opportunity and firm value. These findings suggest that, at present, ESG Risk Rating information in Indonesia is not considered relevant by investors in assessing corporate performance.*

## Introduction

As the Indonesian economy develops, the progress of sustainability aspects in Indonesia is also being positively responded to by both local and foreign investors. According to PricewaterhouseCoopers (PwC) in its December 2021 article titled 'Indonesia's Sustainable Transformation,' foreign investors are striving to encourage the Indonesian government to adopt ESG (environmental, social, and governance). Additionally, the Indonesian government is also proactively creating conditions that support the transition towards ESG and Sustainable Development Goals (SDGs) (Nareswari et al., 2023). With pressure from investors and government policies, companies in Indonesia are encouraged to identify environmental, social, and governance (ESG) risks and opportunities and integrate them into their business strategies (PwC, 2021).

To support the *Sustainable Development Goals*, companies in Indonesia must improve their environmental, social, and governance disclosures. However, according to data from the Indonesia Stock Exchange, companies in Indonesia are still lagging in implementing businesses based on ESG principles (Frank Pan, 2021). The ESG index of the Indonesian capital market only ranks 36th out of 47 capital markets in the world as of March 2021. Even below the Philippines, Singapore, Malaysia, Thailand, and India (Rahmadani, 2022). To support ESG implementation, the Indonesia Stock Exchange publishes the ESG *Leaders Index,* which contains 30 companies with the highest ESG rankings. This aims to encourage the implementation of sustainable investment in Indonesia. In addition to *ESG Leaders*, companies listed in the LQ45 Index, which consists of 45 stocks with relatively large capitalization, high liquidity, and good fundamentals, are also required to report ESG risk rating *(Idx, 2024)*.



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The author chose the LQ45 Index companies listed on the IDX as the object of research for several reasons. First, Indonesia is a developing country with different characteristics from developed countries, so the role of ESG performance may have different effects. Second, the ESG Index in Indonesia is still relatively low and can be seen as an opportunity and a threat for the government to improve the ESG Index and support the SDGs. Third, the LQ45 Index consists of various companies from several different sectors and relatively unequal ESG risk ratings.

Recently, the question has been raised whether ESG risks really matter for firm value. This question seems relevant given that many recent findings on foreign exchanges about ESG implementation have yielded positive results for companies, as they can further expand their business markets. In addition, there is a positive correlation between high ESG ratings and investor confidence, which in turn can reduce the risk of falling stock prices. Li et al. (2022) show that companies with high ESG ratings have a lower risk of falling stock prices, due to better disclosure of information that fosters investor confidence.

A number of studies prove the positive influence between ESG performance and firm value. Velte (2017) shows that ESG has a positive effect on firm value (Tobin's Q). Some multi-country studies also report a negative relationship between ESG to firm value. Duque et al. (2021) examined 104 multinational companies in Latin America from 2011 to 2015. Their findings show that there is a negative relationship between ESG scores and the financial performance of these companies. (Garcia et al, 2020) compared emerging and developed countries through 2,165 companies from 2007 to 2014. They revealed that in emerging markets, the relationship between ESG scores and financial performance is negative.

Indonesia is one of the developing countries in Southeast Asia. This study was conducted to reconfirm whether companies in Indonesia have started to pay attention to sustainability aspects. The focus of many studies has been on how ESG ratings affect firm performance, be it firm value, stock price, and profitability. At the same time, investors are beginning to realize the importance of ESG (Environmental, Social, and Governance) risk ratings in investment decisions (Cohen, 2023). This study examines the effect of ESG risk ratings on firm value. The ESG risk proxy in this study uses the ESG risk rating issued by *Sustainalytic*. *Sustainalytics* is a leading independent ESG data research and rating company in collaboration with the Indonesia Stock Exchange that supports investors around the world in developing and implementing responsible investment strategies.

*Sustainalytics* will conduct an ESG risk assessment for use in the IDX ESG Leaders and LQ 45 indices every 6 months, namely in February and August. That is why the author uses *semi-annual* data in this study. Companies that get a low ESG risk rating have good exposure and management values and minimal controversy (Fachrezi et al., 2024). This indicates that the company is performing well.

Until now, there have been many studies related to *sustainability report* disclosure in the context of ESG. However, research that examines ESG risks based on ESG risk rating is still limited. Previous research using ESG risk rating was conducted by Priandhana (2022), who tested ESG risk with ESG risk rating on the company's financial performance. The results show that there is a negative influence of ESG risk on the company's financial performance. However, the effect of ESG risk on the company's financial performance is still insignificant. Furthermore, Firmansyah et al. (2023) tested ESG risk using ESG risk rating on company risk, the results showed that the two variables still had no significant effect.



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This study is also different from previous studies because this study includes profitability and growth opportunity as other independent variables that can affect firm value and firm size as a moderating variable. Firm value is often used as the main indicator to measure the success and investment attractiveness of a company. In addition to ESG, firm value is also influenced by profitability and growth opportunity.

Several studies have shown that profitability does not affect firm value. Apriyanti et al. (2022) state that profitability does not influence firm value. This is in line with research conducted by Carningsih et al. (2009), Obradovich et al. (2012), and Sucuahi et al (2016). However, in the research of Noor Fauziah *et al*. (2015), profitability has a positive influence on firm value. This is in line with research conducted by Nopiyanti & Darmayanti (2016), Chen & Chen (2011), and Santoso (2018), which states that profitability has a positive and significant effect on firm value.

Growth opportunity also plays an important role in determining firm value. Research conducted by Hermuningsih (2014) found that growth opportunity has a positive effect on firm value. These results are in line with research conducted by Kusumajaya (2011) and Suastini et al. (2016). However, research by Widayanthi & Sudiartha (2018) shows that growth opportunity has no effect on firm value.

This study focuses on answering the effect of ESG risk rating, profitability, and growth opportunity on firm value. The author positions the firm size variable as a moderator to reveal why ESG risk rating, profitability, and growth opportunity can affect firm value. Large companies usually have more resources to implement and report ESG risks and their management, and are more likely to be the focus of public and media attention (D'Amato & Falivena, 2020). Therefore, the influence of ESG disclosure, profitability, and growth opportunity on firm value may differ between large and small companies.

## Literature Review

### Legitimacy Theory

Legitimacy theory is a theory first coined by Dowling & Pfeffer (1975), which focuses on the interaction between companies and society. This theory considers that society is one of the important factors in the development of the company in the long term. This theory states that organizations are part of society, so they must pay attention to social norms because conformity with social norms can make companies more legitimate.

This theory teaches that companies must convince external parties, such as investors, that their activities and performance are acceptable to governments, individuals, and the surrounding community (Gray et al., 1996). Legitimacy theory is associated with this study because it relates to all variables. The higher the ESG, profitability, and growth opportunity, the better the firm value in the eyes of external parties. The bigger the company, the more information external parties get about the company. Therefore, external parties will increasingly believe in the company's performance so that they can consider investing in the company.

### Agency Theory

This theory was proposed by Stephene Ross and Barry Mitnick in 1970. Then this theory was developed by Jensen and Meckling in 1976. This theory is based on the assumption that the interests of company managers and stakeholders are not fully aligned (Jensen & Meckling, 1976). The agent is authorized to make decisions on behalf of the principal. In the context of a company, the agent is the management of the company, and the principal is the shareholder. In agency theory, there is a possibility of problems if the agent turns out to have individual



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goals that are not in line with the principal's goals. Agents can have personal goals that ultimately only benefit themselves and harm the principal. Agency problems can increase information asymmetry.

The implementation of ESG can enhance the supervisory function and reduce agency problems by strengthening corporate governance mechanisms (Wu et al., 2022). But on the other hand, it may cause managers to have more projects that are not linear with corporate goals. High profitability and growth opportunity will also improve company performance and show that the company has significant growth potential. In addition, the size of the company reflects the development of the company, which shows that the management has successfully established a good relationship with investors through the agreed contract. Therefore, the value of the company in the market will also increase.

**Firm Value**

Firm value is an important indicator that reflects the welfare of shareholders. According to Gunardi et al. (2022), firm value is a condition in which a company will gain public trust in its operational activities since the company was founded. Firm value can be said to be the price sold based on the agreement that the buyer can pay. Franita (2018) explains that firm value is related to investment opportunities formed from indicators of stock market value. This relationship will create a company's growth opportunity in the future. This will have a positive impact so that the firm value can increase. According to the theory of firm value, the higher the value of the company, the higher the welfare of shareholders. Firm value is influenced by various factors, including financial performance, market conditions, and company policies.

**ESG Risk Rating and Firm Value**

A number of studies prove the positive influence between ESG performance and firm value. Velte (2017) showed that ESG has a positive effect on firm value (*Tobin's Q*). To explore the relationship between ESG performance and energy sector financial indicators, Zhao et al. (2018) reviewed energy sector companies listed in China and found that ESG performance has an effect on improving corporate financial performance. According to Dalal & Thaker (2019), who examined 65 Indian companies between 2015 and 2017, found that ESG scores have a positive effect on corporate financial performance. Fatemi et al. (2018) investigated US companies from 2006 to 2011 and found that strength in ESG activities and reporting increases firm value.

Fatemi et al. (2018) investigated US companies from 2006 to 2011 and found that strength in ESG activities and reporting increases firm value. Research by Naeem et al. (2022 in Aydoğmuş et al., 2022) using 1042 companies from developing countries from 2010 to 2019 showed that ESG performance has a positive effect on financial performance. They explained that individual and combined ESG scores have a positive and significant influence on firm value (*Tobin's Q*) and profitability (ROA).

However, if associated with the risk, ESG will have an opposite relationship. Companies with a high ESG risk rating tend to get a negative response from investors, which can reduce the value of the company (Fachrezi et al., 2024). ESG risk rating assesses the extent to which the company's economic value is at risk due to Environmental, Social, and Governance factors. The value of the company here is related to the response of investors in the capital market, which is reflected in the stock price. Thus, companies that have high ESG risk can reduce investor response, resulting in low firm value.



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ESG risk rating is one of the measurement tools used by companies, financial markets, and academics to evaluate corporate sustainability. ESG risk rating assesses the extent to which a company's economic value is at risk due to Environmental, Social, and Governance factors. The Indonesia Stock Exchange (IDX) always encourages sustainable and responsible investment in the capital market. In terms of ESG risk rating reporting, the IDX collaborates with Morningstar Sustainalytics.

Morningstar Sustainalytics uses a risk decomposition methodology to evaluate ESG (Environmental, Social, and Governance) risks. This approach considers two main dimensions in its measurement. These are the exposure dimension and the management dimension. The exposure dimension measures the extent to which a company is exposed to ESG risks, while the management dimension assesses how the company handles those ESG risks. The (Von Münchhausen et al., 2024). ESG risk rating is categorized into five risk levels from very low to very high

Table 1. ESG Risk Rating

| Risk Score | Category | Description |
|---|---|---|
| 0 - 10 | Negligible | Considered to have negligible ESG Risks |
| 10 - 20 | Low | Considered to have low ESG Risk |
| 20 - 30 | Medium | Considered to have moderate ESG Risk |
| 30 - 40 | High | Considered to have high ESG Risk |
| >40 | Severe | Considered to have severe ESG Risks |

Source: ESG Risk Rating (Von Münchhausen et al., 2024)

ESG risk rating reflects a company's exposure to environmental, social, and governance risks. Companies with high ESG risk may experience decreased investor confidence because they are considered unable to face sustainability challenges (Fatemi et al., 2018). Signaling theory explains that ESG disclosure can signal a company's commitment to sustainability to stakeholders. By disclosing their ESG practices and performance, companies can demonstrate their dedication to environmental, social, and governance responsibilities. This can reduce the company's risk.

Reducing a firm's risk can generally increase its market value (Bolibok, 2024; Brogi et al., 2022). Therefore, it is not surprising that over the past few years, most empirical evidence documents a positive relationship between a firm's ESG disclosure and its financial performance (Friede et al., 2015). Among the many studies focused on ESG disclosure, investors have begun to realize the importance of ESG risk in investment decisions (Cohen, 2023). ESG risk is measured by a score for each component, where the greater the score, the more dangerous the risk.

A high ESG risk rating may trigger a negative response from investors. Investors may see high ESG risk as an indication that the company is not fully capable of managing such issues effectively, which in turn may lower their confidence in the value of the company. This can have a negative impact on the company's value and the market's perception of the company's overall reputation. These empirical findings in previous studies support the first hypothesis in this research.



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$H_1$: ESG risk rating has a negative effect on firm value.

**Profitability and Firm Value**

Profitability is the company's ability to generate profits with all the assets owned by the company (Brigham & Houston, 2016). Profitability reflects the company's performance on the return of all assets (funding) provided to the company. High profits will cause the demand for shares to increase, and the share price will increase and resulting in the return earned by investors also increasing, so that it can also increase the value of the company (Masdupi et al., 2018; Santosa & Laksana, 2011).

In this study, profitability is measured using ROA (*Return on Assets*). Analysts and market professionals usually use ROA more often in measuring company profitability. This ratio shows the company's ability to generate profits with all its assets owned by the company. The higher the ROA, the company uses its assets effectively and efficiently in generating profits.

Several studies have shown that profitability does not affect firm value. Apriyanti et al. (2021) state that profitability does not affect firm value. This is in line with research conducted by Sussanto & Carningsih (2009); Obradovich et al. (2012); Sucuahi & Cambarihan (2016) found that profitability does not affect firm value.

According to Miller & Modigliani (1961), the value of the company is determined by the earnings power of the assets owned by the company. High earning power will encourage the efficiency of asset turnover so that it will result in the company's profit margin increasing, which in turn has an impact on firm value. Research conducted by Noor Fauziah et al. (2015) found that profitability has a positive influence on firm value. This is in line with research conducted by Nopiyanti & Darmayanti (2016); Chen & Chen (2011); Santoso (2018), which states that profitability has a positive and significant effect on firm value. These empirical findings in previous studies support the second hypothesis in this research.

$H_2$: Profitability has a positive effect on firm value.

**Growth opportunity and Firm Value**

Growth opportunity is the growth opportunity of a company in the future (Mai, 2006). Growth opportunity is used by investors to assess the development of a company. Companies that always grow every year will find it easier to attract external parties to invest, which can cause an increase in the value of the company. Information about the company's growth will be responded to positively by investors, so that it will increase the stock price.

Several studies show that growth opportunity has no effect on firm value. Putri (2016) research shows that growth opportunity has no effect on firm value. This is in line with research conducted by Fauziah et al. (2015), Wardjono (2010), and Widayanthi & Sudiartha (2018). In this study, growth opportunity is measured by *Market to Book Value of Equity* (MBVE). According to Nurcahyo & Putriani (2009), *Market to Book Value of Equity* (MBVE) is a proxy for *Investment Opportunity Set* (*IOS*). This proxy measures the company's growth from its ability to obtain and manage its own capital. Companies that are predicted to experience growth in the future tend to have higher firm values.

Growth opportunity for each company is different. Growth opportunity is a condition where the company can create opportunities in the future. Research conducted by Hermuningsih (2014) found that growth opportunity has a positive effect on firm value. These results are in line with research conducted by Kadek & Kusumajaya (2011) and Suastini et al. (2016). This positive relationship is because if the company's growth opportunity level increases, investors



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will see this as one of the good indicators for the company's future growth prospects, which will later affect the company's value. These empirical findings in previous studies support the third hypothesis in this research.

$H_3$: Growth opportunity has a positive effect on firm value.

**Firm Size Interaction Effect**

Firm size is often used as a moderating variable in financial research. Firm size can affect the relationship between independent and dependent variables because larger firms may have different resources and capabilities compared to smaller firms. Both in the context of ESG risk rating, profitability, and growth opportunity are used to assess a company.

There are several reasons why firm size may affect the relationship between ESG and firm value. First, large companies tend to have more assets than small companies (D'Amato & Falivena, 2020). This condition makes large companies able to invest more in sustainable ESG projects. In addition, large companies are more able and motivated to disclose ESG information due to greater public scrutiny and the need to meet broader stakeholder expectations. Large companies also have better access to financial and managerial resources that enable them to implement better corporate governance and operations. They are considered to have better strategies and objectives in monitoring business activities. Therefore, large companies are in a better position to implement ESG principles.

Firm size is one of the variables used in determining the value of a company. Firm size is a reflection of the total assets owned by a company. The company itself is categorized into two types, namely small-scale companies and large-scale companies. Research conducted by Pratama & Wiksuana (2016, in Nur 2019) found that firm size has a positive effect on firm value. If the size of the company affects the profitability of the company, then the larger the size of the company, the more its profitability will increase, which in turn can increase the value of the company.

Similar conditions also occur in growth opportunity, firm size can moderate the effect of growth opportunity on firm value. Large companies can produce at large economies of scale, can obtain discounts on raw materials, are better at managing receivables, and have greater access to sources of funds to finance their investments than small companies (Setiawan, 2009). Therefore, the effect of growth opportunity on the value of the company will be stronger in large companies than in small companies. The empirical findings in the above research support hypotheses four (a) to four (c) in this research.

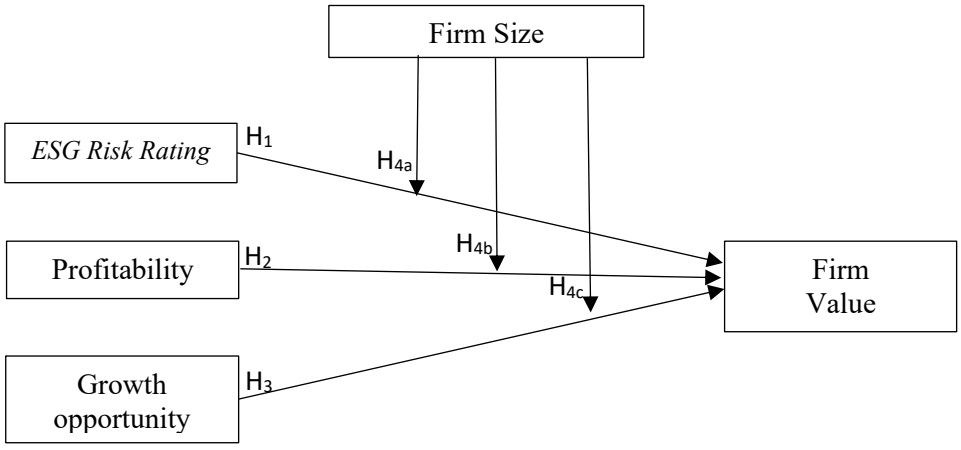


*Figure 1. Framework of Thought*



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$H_{(4a)}$: Firm size weakens the effect of ESG risk rating on firm value.

$H_{(4b)}$: Firm size strengthens the effect of profitability on firm value.

$H_{(4c)}$: Firm size strengthens the effect of growth opportunity on firm value.

## Methods

This research uses quantitative methods. In this study, the population is companies listed on the Indonesia Stock Exchange from 2019-2024 using *semi-annual* data. The dependent variable in this study is firm value as measured using *Tobin's Q. Tobin's Q* is the ratio between the market value of a company and its intrinsic value. In other words, the company's market value divided by the cost of replacing its assets will be able to determine whether the company is too expensive or too cheap.

This research model involves three independent variables, namely ESG risk rating, profitability, and growth opportunity. ESG risk rating is measured using Risk rating scores as used in Morningstar Sustainalytics reporting (Von Münchhausen et al., 2024). Morningstar Sustainalytics uses a risk decomposition methodology to evaluate ESG (Environmental, Social, and Governance) risks. This approach considers two main dimensions in its measurement. These are the exposure dimension and the management dimension. The exposure dimension measures the extent to which a company is exposed to ESG risks, while the management dimension assesses how the company handles those ESG risks. The ESG risk rating is categorized into five risk levels from very low to very high.

The second and third independent variables are profitability and growth opportunity. Profitability measures the success or failure of a company in a certain period of time. Profitability refers to the ability of a company to generate income compared to its assets. In this study, profitability is measured using ROA (*Return On Assets*). The last independent variable is growth opportunity. Growth opportunity is a condition where the company can create opportunities in the future, this causes the growth opportunity for each company to vary. In this research, growth opportunity is measured using the *Market to Book Value Ratio.*

This research develops three research models, each of which is described in three econometric equations. Each equation shows the relationship between variables and their measurements, which are presented mathematically in the following section.

$$TSQ_{it} = \alpha + \beta_1 ESG_{it} + \beta_2 ROA_{it} + \beta_3 MBV_{it} + \varepsilon_{it} \quad (1)$$

$$TSQ_{it} = \alpha + \beta_1 ESG_{it} + \beta_2 ROA_{it} + \beta_3 MBV_{it} + \beta_4 SIZ_{it} + \varepsilon_{it} \quad (2)$$

$$TSQ_{it} = \alpha + \beta_1 ESG_{it} + \beta_2 ROA_{it} + \beta_3 MBV_{it} + \beta_1 SIZ_{it} + \beta_5 (ESG * SIZ)_{it} + \beta_6 (ROA * SIZ)_{it} + \beta_7 (MBV * SIZ)_{it} + \varepsilon_{it} \quad (3)$$

Description:

$\alpha$ = Constant

$\beta$ = Regression Coefficient

*TSQ* = Firm Value

*ESG* = *ESG Risk* Rating

ROA = Profitability

MBV = Growth opportunity

SIZ = Firm Size



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$\varepsilon$ = Residuals

Testing these models is done by processing research variables. Details of research variables and measurement proxies can be seen in Table 2.

Table 2. Summary of Research Variables and Measurements

| Variables | Description | Measurement |
|---|---|---|
| TSQ-Tobin's Q | Used to measure the value of the company (a condition in which the company gets public trust from operational activities since the company was founded). | $TSQ = \frac{Equity\ Market\ Value + Total\ Liabilities}{Total\ Aset}$ *(Giannopoulos et al., 2022)* |
| ESG Risk Rating | Used to assess the extent to which a company's economic value is at risk due to environmental, social, and corporate governance factors. | Using *ESG Risk Rating* Morningstar Sustainalytics (Von Münchhausen et al., 2024) |
| ROA-Return on Assets | Used to measure the company's profitability (the company's ability to generate net income compared to its total assets). | $ROA = \frac{Net\ Income}{Total\ Assets}$ (Dalal & Thaker, 2019) |
| MBV-Market to Book Value | Used to measure company growth (assessing whether the company is developing or not). | $MBVE = \frac{Jumlah\ Saham\ Beredar\ X\ Closing\ Price}{Total\ Ekuitas}$ (Ananda & Nugraha, 2016) |
| Firm Size | Scale of company size as seen from the total assets or market capitalization of a company or organization. | Natural Logarithm of Total Assets *(Wendy, 2020)* |

Source: Processed Data, 2024

Data analysis using Eviews 12 software. The analysis stage begins with descriptive statistical testing, model selection, and basic assumptions to analyze whether the observational data can proceed to further testing. The feasibility and goodness of fit model test is conducted by analyzing the results of the F test and the model's coefficient of determination. Meanwhile, regression analysis is carried out in two stages. First, analyzing the impact of ESG Risk Rating, profitability, and growth opportunity on firm value. Second, analyzing the results of the interaction effect of firm size in explaining the impact of ESG Risk Rating, profitability, and growth opportunity on firm value. Interpretation of results is carried out after all tests are completed.

## Result and Discussion

This section presents the results of statistical testing through 3 estimation models. The analysis stage begins with descriptive statistical testing, model selection (*Chow Test* and *Hausman Test)*, and basic assumption tests. Furthermore, the *goodness of fit model test* and panel data



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regression testing through three estimation models are conducted. The results of descriptive statistical testing and model selection in detail are presented in Table 3 and Table 4.

Table 3. Descriptive Statistics

| Description | TSQ | ESG Risk Rating | ROA | MBV | SIZ |
|---|---|---|---|---|---|
| Mean | 2.069 | 32.364 | 0.062 | 4.646 | 32.411 |
| Median | 1.194 | 29.840 | 0.041 | 1.510 | 32.260 |
| Maximum | 78.340 | 62.020 | 0.454 | 303.359 | 35.353 |
| Minimum | 0.696 | 17.420 | -0.029 | 0.474 | 30.424 |
| Std. Dev | 5.288 | 8.407 | 0.069 | 20.906 | 1.380 |
| Skewness | 12.763 | 0.859 | 2.473 | 12.467 | 0.590 |
| Kurtosis | 182.262 | 4.177 | 10.659 | 175.587 | 2.255 |
| Observation | 240 | 240 | 240 | 240 | 240 |

Source: Processed Data, 2024

The descriptive statistics in Table 3 above show that the *mean* value for each variable (TSQ, *ESG Risk Rating*, ROA, MBV, and SIZ) is in the range of 2.069 to 32.411. This distribution indicates a relatively good variation value, which is supported by stable standard deviation data (in the range of 0.069 to 20.906), so that extreme observation data is not found. These conditions support the next stage of testing (model specification), which can be seen in Table 4 below.

Table 4. Selection of Estimation Model

| Method Test | Chi-Square | Probability |
|---|---|---|
| Chow Test | 139.451698 | 0.0000 |
| Hausman Test | 21.112907 | 0.0003 |

Source: Processed Data, 2024

The results in Table 4 show that in the *Chow* Test, the probability value for the cross-section chi-square test is 0.0000, which is smaller than 0.0500, indicating that the selected model is a *fixed effect model*. Similarly, in the *Hausman* Test, the probability value for the chi-square test is 0.0003 and is also smaller than 0.0500, which indicates that the selected model is a *fixed effect model*. Through the *Chow* and *Hausman* tests, it can be concluded that the *fixed effect model* is the most appropriate for this study.

Basic assumption testing is conducted before testing the estimation models. The results of the residual normality test using the *Jarque-Bera* method show that the data is not normally distributed (probability value below five percent). However, this result can be ignored because, based on the concept of *the central limit theorem, a* large number of observations are assumed to follow the normal distribution (Gujarati & Porter, 2009). This research analyzes 240 observations that statistically fall into the large sample category so that they can follow the assumptions in *the central limit theorem.* Furthermore, three estimation models were tested, the detailed results of which can be seen in Table 5.

Table 5. Summary of Model Testing Results

| Variabel | Model 1 | Model 2 | Model 3 |
|---|---|---|---|
| | TSQ | TSQ | TSQ |
| Konstanta | 0.689 | 15.280 | 20.681 |
| P-value | (0.019)** | (0.016)** | (0.045)** |



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| | | | |
|---|---|---|---|
| ESG Risk Rating | 0.002 | -0.001 | -0.018 |
| P-value | (0.793) | (0.887) | (0.937) |
| ROA | 1.609 | 1.963 | 51.679 |
| P-value | (0.050)** | (0.018)** | (0.115) |
| MBV | 0.259 | 0.259 | -4.990 |
| P-value | (0.000)*** | (0.000)*** | (0.000)*** |
| SIZ | - | -0.447 | -0.633 |
| P-value | - | (0.021)** | (0.049)** |
| ESG*SIZ | - | - | 0.001 |
| P-value | - | - | (0.931) |
| ROA*SIZ | - | - | -1.570 |
| P-value | - | - | (0.132) |
| MBV*SIZ | - | - | 0.171 |
| P-value | - | - | (0.000)*** |
| F | 870.139 | 855.463 | 824.069 |
| P-value | (0.000)*** | (0.000)*** | (0.000)*** |
| Adjusted $R^2$ | 0.989 | 0.989 | 0.990 |

Note: Dependent variable=TSQ; significance sign *,**,*** = 10%, 5%, and 1%, respectively.

Source: Processed Data, 2024

Based on Table 5, each model shows a probability value of 0.0000. This value is smaller than 0.0500, which indicates that each model in this study shows a good regression model fit. The adjusted R-squared value in Table 5 is quite high for each model (0.989, 0.989, & 0.990). These results indicate that the variation in the independent variables can explain the variation in the dependent variable very well.

Model-1 test results show that the ESG risk rating variable has no significant effect on firm value (TSQ), while profitability (ROA) and growth opportunity (MBV) show a positive and significant effect on firm value (TSQ). Thus $H_1$ is not supported while $H_2$ and $H_3$ are statistically supported at the five percent and one percent levels, respectively.

The model-2 test results show that the ESG risk rating variable has a negative but insignificant effect on firm value (TSQ), while profitability (ROA) and growth opportunity (MBV) remain consistent with the model-1 test results which show a positive and significant effect on firm value (TSQ). The test results in model 2 also confirm that the firm size variable has a predictor role on firm value (TSQ). The statistical test results show that firm size has a significant negative effect on TSQ at the five percent level.

Testing the interaction effect to test firm size as a moderating variable is carried out in Model 3. The results of model-3 testing after including firm size show that firm size cannot moderate ESG risk rating and profitability (ROA) on firm value (TSQ). Firm size is only able to moderate the growth opportunity on firm value to a significant degree of one percent. The firm size variable in model 3 shows a significant negative effect (5%), which indicates that the SIZ variable also has a predictor role, so that it is more directed towards quasi moderators.

**Repositioning ESG, Profitability, and Growth within Valuation Practices in Transitional Economies**

The lack of a statistically significant correlation between ESG risk ratings and firm value in the present study requires a particularly serious re-evaluation of the earlier hypothetically linear relationship between sustainability disclosures and market valuation. Such relationships have



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been long argued in the global academic literature, especially on developed markets, according to which the ESG performance works as a cue to reduced firm-specific risk and of better long-term performance (Fatemi et al., 2018; Brogi et al., 2022; Giannopoulos et al., 2022). However, such agreement comes on the basis of financial structures where the issues of ESG are thoroughly empowered and shape the psychological expectations of investors and rule-makers. In Indonesia, a dark contrast is in place: ESG integration is at best procedural but not fundamental. The frameworks issued by organizations like the IDX along with the endorsement of Sustainalytics have clearly not made ESG ratings feasible to act as signals of firm values among market actors. This deviation cannot be entirely explained by using methodological issues; a larger cultural inertia on the capital markets of the emerging economies has to be resorted to. The gap between the availability of ESG disclosure and its operational use is persistent and motivates a conclusion that ESG data have yet to become a practically relevant factor of the company when considering investments in Indonesia.

The likely reason is the limited nature of the significant ESG accountability tools at the levels of corporate and investor responsibility. The ratings discussed in this piece record exposure and managerial ability but do not translate such measures with any economic outcome unless the implementation context provided by strong governance and pressure on investors. Research by Duque-Grisales and Aguilera-Caracuel (2021) and Garcia and Orsato (2020) highlight that in an emerging market, the positive dependence of ESG and the level of financial performance performance depends on the presence of effective governance environments and investor activism.. In the current scenario of Indonesia, the institutional structure that regulates the disclosure of environmental, social, and governance (ESG) is undeveloped. At the same time, the informational asymmetry is very strong because investors are not very knowledgeable on matters about ESG-related issues. This asymmetry constrains the signalling power of the ratings, downgrading ESG ratings to just a step of the process, and not to a tool that can shape the behaviour on the market in any significant way. This is because in an environment where investors lack the appropriate training to interpret the valuation signals brought about by their exposure to ESG factors and where regulators do not institute any penalty on smoking nonchalance towards ESG, the economic usefulness of ratings would disappear

It is also empirically indicated that the irrelevance of ESG in Indonesian valuation is not alleviated by the size of a firm. The literature beforehand also implies that reputational pressure and scrutiny affect larger size firms more, thus motivating them to reveal trustworthy ESG information (D dottigh pregnant line st accetic acid to Amato & Falivena, 2020; Aydo ggrave str damned mizmu mselly tout tab do cons acrit encuenta et al., 2022). This assumption, however, makes the assumption that the institutional environment is one that is in the position to escalate reputational risk. The assumption, that scale simply breeds transparency or ESG responsiveness, fails to see the light of day in Indonesia. Quite the contrary, Bolibok (2024) shows that opacity and the red tape can encourage big players in the emerging markets to avoid holding themselves to account at the behest of the people, which is echoed in our findings. In fact, we find no support to a moderating role of firm size in the relationship between ESG risk and firm valuation and, hence, highlight the empirical hollowness of arguments that the valuation of firms is necessarily less volatile and that size conveys enhanced sensitivity to ESG factors on its own.

Conversely, the unquestioned relationship between firm value and profitability is imbibed deep in the economic theory and behaviour of the investor. In markets where there are issues related to capital scarcity and short run investment nature, profitability is an indication of future cash flow and hence value pricing nexus is reinforced in such situations. In several threads of the literature available, the profitability, and especially the measure of return on equity, is found to



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be a strong driver of the firm value. This proposal is confirmed by Santoso (2018), Fauziah and Sudiyatno (2020) and Chen & Chen (2011). But this is not just a re-statement of the traditional financial theory. Profitability in the Indonesian markets acts as more than a predictor of performance; profitability is used as a process of gaining investor confidence. When long-term strategic or ethical performance is not regularly evaluated in an environment occupied by mature instruments, the investors will be required to depend on financially quantifiable and direct returns. Since such demands have persisted, capital allocation still remains an issue that is guided by the earning quality alongside the returns on the assets that are invested. This trend is supported by the empirical research findings of Cohen (2023) and Chininga et al. (2024), as those authors have shown that in the context of weak enforcing the ESG framework, profitability once again become the chief valuation language.

However, contrary to the expectation, the current study fails to determine that the size of firm moderates value-profit nexus. Rather, it is true that big firms in Indonesia might not necessarily turn profit into higher market value more effectively than that of smaller firms. This finding supports that of diseconomies of scale whereby expansions in scale have been linked with operational inefficiencies, rising civil war between insiders, or decreasing returns on assets brought about by the over-expansion. Investors can thus punish big companies with low profitability rates particularly when such companies focus more on growth or complexity as opposed to affordability. To increase valuation of volatile markets, sustainability and strategic defensibility of profitability should be visible and perceived, as argues by Li et al. (2022). This empirical evidence corroborates the argument of this paper that large size of firms impedes the profitability effects because of lack of strategic clarity or good governance, and hence supports the claim presented in this paper that the simple size effect, in the absence of strategic clarity and governance acuity, can negate the strength of profitability as a signal.

On the other hand, growth opportunity is depicted to be more dynamic and context sensitive when determining the value of firm as it reveals an undifferentiated positive relationship which becomes stronger as the firm increases in size. This finding is in line with investment opportunity set theories and goes in line with previous studies by Hermuningsih (2014), Kusumajaya (2011) and Suastini et al. (2016), which portrays an increment to the value of a firm due to the possibility of the firms growth, which in this case is perceived as feasible and strengthened by assets power. The ability of a firm to portray itself as stable but at the same time as in possession of dynamic growth appears hence as a scarce and precious quality in the Indonesian context where the volatility of the market has always limited excessive speculative investing. The more capital-endowed, infrastructure-established and network-enabled the firms, the more able are they to translate the growth stories into practice. Since, bigger business organizations have high levels of access to credit, smooth supply chains, and bargaining power as seen by Setiawan (2009), they have a higher capacity of achieving strategic opportunities than small business organizations. In line with that, the moderating role played by the firm size turns not only to be statistically significant but also economically sound: an investor pays more on the growth potential when it is supplemented by scale and credibility.

These findings result in theoretical implications. Instead of the assumption that the ESG impact is bound to grow, with the availability of more data, it is imperative to consider the institutional ecosystem of interpreting the metrics. The findings are aligned with those of Landi & Sciarelli (2019) who believe that ESG signaling needs to be interpreted in a collective manner by the media, regulating authorities, analyst groups, and education systems that create meaning around it. Without such institutions, ESG may turn out to be superficial instead of practical. Moreover, the research contributes to the argument by Friede et al. (2015) concerning the need



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to conduct meta-analytical analysis with a country-specific component and a growth path of institutions that direct the financial players to react towards emerging valuation paradigms.

Lastly, this research is significant because it refiles and separates the rhetoric and the real. One may think the issue of ESG discourse is being raised to the plane of ideology in international finance, though it has an uneven pattern of operation and controversy to deal with. Through showing that ESG risk ratings are yet not felt significantly in the valuation of firms in Indonesia, at the same time as profitability and growth still retain their primacy in the minds of investors, this paper reveals the epistemic boundaries of the immediate impact of ESG. It forces the scholars, practitioners and policymakers to oppose the comfort of universal models and instead dedicate themselves to develop valuation frameworks that are more in tune with the socio-financial realities of transitional economies. Further development of ESG will be neither measured nor identified by the metrics but by the political and institutional determination to change the way markets interpret the rewards to sustainable behavior.

## Conclusion

The research paper presents a clear judgment between the controversial position of the ESG risk ratings when it comes to the determination of the firm value in the Indonesian capital market. Regardless of the mounting institutional focus and formalised ESG systems being enforced by international agencies and national authorities, the empirical evidence presented here does well to affirm what many people have suspected and little people have shown. The way ESG risk rating is constructed and applied does not carry credibility as a valuation criterion among the Indonesian investors. The measures are present and do not have the weight of the market. Their failure to affect directly the value of firms, directly, indicates a greater cultural, institutional, and interpretive immaturity that is required to spirit ESG out of being symbolic compliance to change into strategic capital.

This result must not be confused with the condemnation of the ESG as such. Instead, it comes as an invitation to its radical contextual reconsideration. As a practical matter, at least in the transitional economies, ESG has to be translated into systems that mirror the capabilities of the local financial systems, regulatory requirements, and valuation rationales. In the absence of this anchoring, ESG risks will be drifting like unrecognized signals that have nothing to do with the actual decisions investors adopt. This disjuncture has not only been highlighted in this study, but it has also shown that even the size of a firm which is often assumed to have an increasing effect on the visibility of ESG does not change this and this structural indifference. In this regard, the symbolic capital of ESG is not cashed in. The empirical paper of profitability and growth opportunity being powerful predictors of firm value on the other hand justifies the hegemony of old financial thinking of firms commanding markets in which performance is measured by physical attributes. Venture capitalists react to revenue, although revenue and growth potential are determined, and ethical stance is not. The fact that profitability becomes weak when interacting with the size of firms only demonstrates how valuation in emerging contexts is rather complicated and counterintuitive. When scale is not accompanied by governance efficiency, it turns out to be a curse. But when it comes to growth opportunity size will increase the reaction of the market so it is true that the expansion stories can only be believable when supported by structural capacity.

The value of this paper is not only reflected with the matters of theoretical intervention and theoretical intervention, but with the fact that it is clearempirically. It forces us to put into perspective our insights into value formation in the Global South. It reveals how poorly informed the idea of importing valuation models is without making any effort to satisfy the institutional scaffolding that it necessitates. ESG should not be visualized as a ready to fit and



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use application but as a structure that will only be acceptable once immersed in its own ecosystem where rights generate the same level of reward as profit. Indonesia, as most transitional economies, is still far to have this transformation fulfilled. This study marks a definitive step in explaining why.

Future research must shift away from testing ESG's influence in the abstract and move toward deconstructing the institutional mediators that enable or suppress its valuation effect. For policymakers, the implication is even more urgent. ESG cannot be legislated into relevance. It must be made consequential through enforceable disclosures, stakeholder education, and integration into fiscal and investment incentives. Until these conditions are met, ESG will remain a performative index, detached from the real forces that shape firm value in transitional markets.

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