CHAPTER I
INTRODUCTION

1.1 Background

The development of modern capital markets has encouraged investors to consider broader information beyond traditional financial indicators, including non-financial information related to sustainability and corporate governance (Eccles et al., 2014; Friede et al., 2015). Firm risk reflects uncertainty in future outcomes and return variability, while firm value represents the market's assessment of a company's future prospects and value creation ability (Brealey et al., 2020; Damodaran, 2012). As business environments become more complex, non-financial information becomes increasingly relevant because it may provide additional insight into management quality, long-term orientation, and sustainability-related risks (Eccles et al., 2014; Friede et al., 2015).

Financial disclosure plays an important role in reducing information asymmetry between firms and external users of information (Healy & Palepu, 2001). However, financial indicators alone may not fully reflect sustainability-related factors that influence how stakeholders assess a firm, such as environmental responsibility, social issues, governance quality, and corporate reputation (Eccles et al., 2014; Friede et al., 2015). From a stakeholder perspective, these factors are important because firms are assessed by various parties affected by corporate activities, including investors, employees, communities, and regulators (Freeman, 1984). These factors are relevant because firms with different ESG characteristics may exhibit different levels of downside risk, indicating that market participants also consider ESG-related information in assessing firm risk (Lööf et al., 2022). Therefore, ESG information can serve as a complementary indicator in firm assessment.

ESG performance is relevant in firm assessment because it reflects how firms manage environmental, social, and governance-related issues that may affect risk and long-term resilience. Brighi et al. (2025) highlight the strategic relevance of ESG engagement for risk management and value preservation. In addition, Broadstock et al. (2021) show that firms with stronger ESG performance tend to have lower risk exposure and greater resilience during periods of market stress.

From a risk management perspective, ESG performance may function as an insurance-like mechanism by reducing firms' exposure to non-financial risks and helping firms maintain stability during adverse conditions (Brighi et al., 2025; Godfrey et al., 2009).

As ESG information becomes more relevant in capital markets, institutional pressure for transparency and ESG standards has increased. The development of ESG from a voluntary initiative into a more regulated disclosure practice is reflected in global sustainability reporting requirements. For instance, the European Union has introduced the Corporate Sustainability Reporting Directive (CSRD), which strengthens corporate sustainability reporting obligations and requires broader sustainability-related disclosure (Sharma, 2025). This regulatory direction is also supported by the 2023 update to the OECD Guidelines, which emphasizes the importance of due diligence in managing non-financial risks and responsible business conduct (OECD, 2023). The growing relevance of ESG considerations is also reflected in global capital allocation, as the Global Sustainable Investment Alliance (2021) reported that global sustainable investment assets reached USD 35.3 trillion. This figure indicates the increasing scale of capital allocated to sustainability-related investment.

Despite the increasing regulatory and market attention toward ESG, reliance on aggregate ESG scores remains challenging due to measurement issues. Widyawati (2021) emphasizes that ESG ratings often demonstrate low convergence and may represent a firm's formal reporting quality rather than its actual operational integrity. This creates a potential limitation in assessments that rely only on aggregate ESG scores, as proactive disclosures may obscure underlying non-financial risks (Widyawati, 2021). In this context, ESG controversies become relevant as complementary indicators of non-financial risk because they reflect specific negative events, such as human rights violations, labor disputes, or environmental incidents, that may trigger stakeholder and market reactions (Xue et al., 2023).

The relevance of ESG controversies as event-based indicators can be seen from the economic and reputational consequences of ESG-related scandals. Xue et al. (2023) state that ESG scandals are often associated with reputational damage and declines in stock prices, as illustrated by cases such as Volkswagen's emission manipulation scandal and the BP Deepwater Horizon oil spill. The study further shows that ESG-related negative events reduce corporate investment efficiency by increasing information asymmetry and market uncertainty. Therefore, ESG controversies may weaken firm valuation and increase perceived risk in the capital market.

In the context of developing countries, ESG performance may reflect firms' sustainability practices and ability to manage long-term risks, although its relevance depends on institutional conditions and the quality of ESG implementation within each market (Brighi et al., 2025; Broadstock et al., 2021; Widyawati, 2021). Empirical evidence provided by Broadstock et al. (2021), who examine firms listed in the Chinese capital market as a representative emerging economy, indicates that companies with higher ESG performance tend to exhibit lower stock price volatility and greater resilience during periods of financial crisis. These findings are consistent with the risk management perspective, which views ESG performance as a mechanism that may reduce firms' exposure to non-financial risks and provide reputational protection during periods of uncertainty (Brighi et al., 2025; Godfrey et al., 2009). Nevertheless, across emerging markets more broadly, the informational value of ESG performance remains contextual because the quality of disclosure and the consistency of ESG practices may vary across firms and countries.

This issue becomes more relevant in emerging markets, where ESG disclosure practices may still reflect formal compliance rather than actual operational integrity (Widyawati, 2021). Therefore, the existence of ESG controversies highlights a potential blind spot in risk assessments that rely solely on aggregate ESG scores (Widyawati, 2021). From a stakeholder perspective, ESG controversies may indicate failures in meeting stakeholder expectations, as they involve adverse events such as environmental violations, labor disputes, or governance scandals that can trigger negative reactions from markets and stakeholders (Freeman, 1984; Xue et al., 2023).

Empirical evidence from China as a developing-country context suggests that corporate involvement in ESG controversies may have implications for both firm value and firm risk (Ma & Ma, 2025; Xue et al., 2023). A study by Ma & Ma (2025) on companies in China found that ESG controversies significantly depress firm value, primarily through heightened financing constraints and weakened operational performance. In relation to risk, Xue et al. (2023) demonstrate that ESG-related negative events intensify market uncertainty and exacerbate information asymmetry, thereby reinforcing investors' perceptions of risk. These findings underscore that, within emerging markets, ESG controversies may weaken the relevance of ESG performance in reflecting firms' actual risk conditions and generate distinct, potentially adverse effects on firm value and firm risk. This issue becomes particularly relevant for other emerging economies undergoing transitional phases of ESG implementation, including Indonesia.

Indonesia is one of the emerging markets undergoing a gradual transition in integrating ESG considerations into corporate reporting. The Indonesian capital market has formally introduced sustainability principles through Financial Services Authority Regulation No. 51/POJK.03/2017 concerning the Implementation of Sustainable Finance for Financial Services Institutions, Issuers, and Public Companies. This regulation requires financial services institutions, issuers, and public companies to implement sustainable finance and prepare sustainability reports. This regulatory development makes Indonesia a relevant context for examining whether ESG performance and ESG controversies provide meaningful information for assessing firm value and firm risk.

However, the existence of formal ESG regulations does not necessarily guarantee consistent disclosure quality in practice. Prior studies suggest significant variation in the depth and consistency of ESG disclosures in emerging markets, where sustainability reporting may still emphasise regulatory compliance rather than fully reflecting actual environmental, social, and corporate governance practices (Widyawati, 2021; Berg et al., 2022). This condition is particularly relevant for markets undergoing regulatory transition, as ESG performance scores may serve as imperfect indicators of actual sustainability behaviour, especially in sectors with high environmental and social exposure (Widyawati, 2021). Under such circumstances, ESG controversies become increasingly relevant as complementary indicators of non-financial risk, as they capture concrete adverse events that may not be fully reflected in aggregate ESG scores (Xue et al., 2023).

Despite the growing literature on ESG performance, ESG controversies, firm value, and firm risk, prior studies still report mixed and context-dependent findings across different firm types, countries, and sectors (Brighi et al., 2025). Compared with studies using global samples or large emerging markets such as China, empirical evidence focusing specifically on Indonesia remains relatively limited. In addition, previous research has often examined ESG performance or ESG controversies separately, while a joint assessment of their different implications for firm value and firm risk remains important. In the context of Indonesia, where ESG regulations have been formally introduced but disclosure practices are still evolving, the informational role of ESG indicators remains an open empirical question. Thus, this study analyzes the impact of ESG performance and ESG controversies on firm value and firm risk among non-financial companies listed on the Indonesia Stock Exchange.

1.2 Problem Formulation

Based on the background presented earlier, the focus of the research problems in this study are:

1.3 Research Objective

Referring to the research problems listed above, this study aims to:

1. To examine the effect of ESG performance on firm value.
2. To examine the effect of ESG performance on firm risk.
3. To examine the effect of ESG controversies on firm value.
4. To examine the effect of ESG controversies on firm risk.

1.4 Research Benefit

The expected benefits of this research are as follows:

1. Theoritical Benefits

   This study is expected to contribute to the existing literature on corporate sustainability by providing empirical evidence on the role of ESG performance and ESG controversies in explaining firm value and firm risk, particularly in the context of emerging markets. By analyzing

ESG performance and ESG controversies simultaneously, this study enriches the understanding of how different ESG dimensions convey information to the capital markets.

2. Practical Benefits

   This study is expected to provide several practical benefits for various parties, including:

   a. For the Author

      This research helps the author to deepen understanding of ESG performance and ESG controversies, particularly in relation to firm value and firm risk in the Indonesian capital market. In addition, this study provides practical experience in conducting empirical research and applying accounting and finance theories learned during undergraduate studies.

   b. For the Academics

      The findings of this study may serve as an additional reference for academics and future researchers who are interested in ESG-related studies, especially those focusing on emerging markets such as Indonesia. This research is expected to enrich the existing literature on ESG performance, ESG controversies, and firm value and risk.

   c. For the Society

      This study may contribute to broader public understanding of how ESG-related information is relevant in assessing companies in the capital market. By discussing ESG performance and ESG controversies, this research may encourage greater awareness of sustainability issues and corporate responsibility in Indonesia.

1.5 Writing Systematic

The researchers compiled their discussion systematically using a structured writing framework consisting of five chapters. Chapter I Introduction reviews the background of the problem, formulates the problems to be studied, sets out the objectives and benefits of the research for various parties, and provides an overview of the writing structure. Chapter II, Literature Review, explains the relevant theoretical basis and refers to previous studies that support the analysis and development of hypotheses. Chapter III, Research Methodology, explains the methodology used, starting from the research design, population and sample, data collection methods, to the variables and data analysis techniques applied. Chapter IV Results and Discussion presents the results of data processing obtained in the field and an in-depth analysis of the research findings. Chapter V Conclusion provides a comprehensive summary of the discussion, acknowledges the limitations of the research, and offers constructive recommendations that may be useful to readers.