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The Influence of ESG Disclosures on Financial Distress Considering The Director's Financial Expertise as a Moderating Factor

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A B S T R A C T

This research study is focused on examining the relationship between disclosures related to Environmental, Social, and Governance factors and their impact on Financial Distress, as well as the potential moderating influence of Director's Financial Skills. The study employs a quantitative methodology and specifically concentrates on companies within the Consumer Cyclical subsector that are listed on the Indonesia Stock Exchange (BEI) throughout the period spanning from 2019 to 2021. Data utilized in this study is derived from both financial reports and annual company reports. The sample for this research was selected through purposive sampling methods, resulting in a total of 108 companies being included. The analysis involved the use of Panel regression techniques, specifically employing a Random Effect Model. The results of the study reveal a noteworthy correlation between ESG disclosures and Financial Distress, with a probability value that falls below the 5% threshold. Moreover, it was found that the presence of Director's Financial Skills significantly strengthens the connection between ESG disclosures and Financial Distress, with a probability value of 0.000 or less than 5%.

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1. INTRODUCION

Bankruptcy and PKPU applications in Indonesia have shown a consistent annual increase. According to a report by Media Rakyat Merdeka, the year 2019 saw 435 such applications, a figure that surged to 726 in 2021, marking the highest number recorded by the Supreme Court. This notable escalation is largely attributed to the repercussions of the Covid-19 pandemic. The pandemic not only disrupted global health systems but also had far-reaching impacts on the global economy and business resilience. Notably, the tourism sector in Indonesia experienced a significant downturn in 2020. In response, the government introduced new regulations to limit community activities, resulting in a substantial 78% decline in tourism sector visitors, equivalent to 1139 million individuals. Consequently, the industry witnessed a staggering 90% drop in revenue. As a constituent of the Consumer Cyclical sub-sector, the Tourism Industry, which provides non-primary goods, bore the brunt of the pandemic's effects. Research indicates that sectors such as tourism, entertainment, and retail have been among the hardest hit by the pandemic. To effectively address these challenges, Indonesia's industrial sector must proactively explore innovative strategies, including the utilization of technology and remote systems.

According to the PKPU review data, numerous companies are presently encountering operational interruptions, necessitating a heightened emphasis on their financial performance. The success of a company's business endeavors critically depends on comprehensive planning that encompasses tax, financial, and governance management, as highlighted by Rachmawati et al. (2019), Ramayanti & Setiawan (2021), and Lastiati et al. (2020). Financial performance stands as a pivotal metric reflecting a company's accomplishments, as noted by Zamzami & Novita (2021). The imperative nature of conducting financial analysis lies in its ability to proactively address bankruptcy risks that could potentially undermine business continuity, as emphasized by Wahyuni & Novita (2021). Winarti et al. (2017) advocate for stakeholders to diligently mitigate bankruptcy risks through thorough analysis.

The concept of corporate sustainability has garnered increased attention, with stakeholders acknowledging the profound influence of business operations on the environment and society, as outlined by Saadat et al. (2020). Embracing corporate sustainability entails the adoption of Environmental, Social, and Governance (ESG) practices to fulfill obligations towards the environment and society, as emphasized by La Rosa et al. (2018). Environmental responsibility encompasses endeavors aimed at reducing ecological footprints, mitigating environmental damage, and enhancing sustainability through effective waste management, energy efficiency, and preservation of natural resources. Aristiningtyas & Fidiana (2023) illustrate the impact of environmental factors on investment risk in their research.

ESG disclosures hold significant importance for investors in their deliberations on investment decisions, serving as a means to evaluate prevailing risks and opportunities (Chalmers et al., 2021). Investors place considerable emphasis on ESG factors within their investment portfolios, recognizing the potential positive impact on the overall value of companies (Giannopoulos et al., 2022). The disclosure of non-financial information conveys a company's core values and can significantly influence the perception of its value and performance (Mohammad & Wasiuzzaman, 2021). Effective disclosure practices play a pivotal role in mitigating financial distress risks for companies, even during periods of crisis (Broadstock et al., 2021; Giannopoulos et al., 2022). Enhanced ESG ratings have been associated with decreased risks across various domains, with each ESG element contributing to risk management efforts (Citterio & King, 2021). Chiaramonte et al. (2022) underscored the impact of ESG ratings on banking insolvency, emphasizing the importance of social value. ESG disclosures in Indonesia adhere to well-established norms, with the Global Reporting Initiative (GRI) serving as a fundamental framework for such disclosures.

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The widespread adoption of GRI standards in the nation centers on the transparent reporting of corporate responsibility concerning critical issues (GRI, 2024).

The preparation of sustainability reports or annual reports explaining ESG disclosures is conducted by a variety of stakeholders, including the board of directors. The board holds a pivotal position within the company's organizational framework, overseeing decision-making processes and setting strategic goals to realize corporate objectives. The efficacy of ESG reporting is intricately linked to the board's active participation, as their attributes significantly influence the quality of the company's ESG disclosures. Engaged in continual monitoring and risk mitigation, the board ensures operational efficiency and remains adaptable to fluctuations in the market. The expertise of a director is paramount in the identification and mitigation of risks, the prevention of regulatory infringements, and the effective management of financial resources. A director's educational background plays a critical role in shaping their comprehension of stakeholders' requirements, with practical experience complementing formal learning. Academic qualifications such as an MBA or a degree in economics contribute to the development of a director's acumen and decision-making skills, particularly in financial matters. Professional experience in the realm of finance further enhances a director's grasp of economic uncertainties, consequently augmenting the quality of decision-making and the depth of management insight.

Directors who have a strong grasp of financial matters play a vital role in steering the company towards success, especially in challenging times like the current pandemic. Their keen oversight of the company's financial health and their ability to assess risks during uncertain economic conditions are truly commendable. Moreover, directors who prioritize sustainability by incorporating ESG disclosures into their strategies are paving the way for a more transparent business environment, showcasing the company's commitment to environmental and social responsibility. By embracing these practices, directors can attract investors who value sustainability, fostering stronger investor relations and creating a positive image that can boost the company's overall worth.

This research study brings a fresh perspective by evaluating ESG indicators using innovative scoring methods. In the Indonesian context, there has been a lack of studies focusing on ESG disclosure with scoring techniques, making this research particularly groundbreaking. Previous studies have mainly explored the impact of ESG factors on separate aspects, as seen in the work of Aristiningtyas & Fidiana (2023). Furthermore, the study dives into the financial expertise of directors as a moderating factor in the relationship between ESG disclosure and Financial Distress. By introducing Confirmatory Factor Analysis (CFA) to enhance the reliability of financial competency indicators, this research sets itself apart. The study's uniqueness also shines through its sample selection process, which involves a research sample from the Consumer Cyclical sub-sector spanning from 2019 to 2021.

2. RESEARCH METHODOLOGY

Sample

This research method is quantitative. Quantitative research data is collected using a quantitative approach to measure, analyze, and understand phenomena through number-based data or measurable variables. Various research methods are utilized for data collection (Sugiyono, 2019). The secondary data source includes annual and financial reports, accessible on the official websites of the Indonesian Stock Exchange (BEI) (www.idx.co.id) and the companies' official websites for the 2019-2021 period report. The research population consists of Consumer Cyclical sub-sector companies listed on the Indonesian Stock Exchange and available on Unair's

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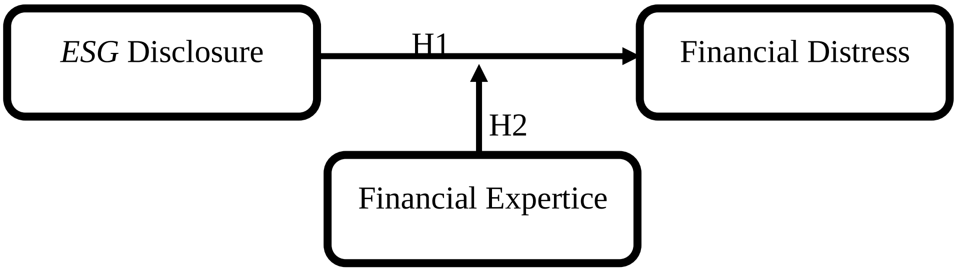
ESGI datastream. Purposive sampling was employed to select a sample based on research objectives and specific needs. The criteria for sampling (Sugiyono, 2019) are as follows:

1. Consumer Cyclical sub-sector companies listed on the Indonesian Stock Exchange (BEI) for the 2019-2021 period
2. Consumer Cyclical sub-sector companies that publish financial reports on personal websites or the IDX website for the 2019-2021 period
3. Consumer Cyclical sub-sector companies that publish annual sustainability reports on the IDX website and ESGI Datastream Unair.

The selected research sample consisted of 108 companies within the 2019-2021 timeframe. Data analysis utilized a panel data regression statistical approach to understand the relationship between variables in a model using panel data, combining cross-time (time series) and cross-junction (cross-section) properties.

Model

Based on the theory that has been described, along with previous research that underlies it theory, the framework of this research can be described as follows:



Gambar 1. Research Framework.

Figure 1 shows the research framework explaining the relationship between ESG disclosure under Financial Distress conditions. The equation model that will be formed for this research are as follows:

$$FD_{t+1} = \beta 0 + \beta_1 ESG_{it} + \beta_2 CR_{it} + \varepsilon$$

The second model is to test the director's financial expertise as a moderator strengthen the relationship between ESG disclosure and Financial Distress.

$$FD_{t+1} = \beta 0 + \beta_1 ESG_{it} + \beta_2 FE_{it} + \beta_3 ESG_{it} * FE_{it} + \beta_4 CR_{t+1} + \varepsilon$$

Financial Distress is a response to disclosures made by Company. Therefore, when ESG is measured for year t, Financial Distress is measured for year t+1. Likewise, measuring the Current Ratio as a control variable uses t+1 assumption.

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Measurement

Tabel 1. Operasional Variable Definition

Research Variable	Measurement
Financial Distress (FDes) Saputra et al., (2021); Fambudi et al., (2023)	Using the Altman Z-Score method, the value will be multiplied by -1. $FDes_{t-1} = (-1\,X\,Z - Score\ t + 1)$
***ESG* Disclosure** Aristiningtyas & Fidiana, (2023); Fambudi et al., (2023)	$ESG = \frac{Number\ of\ Indicators\ disclosed}{Number\ of\ Indicators\ provided\ by\ the\ company}$
Director's Financial Expertice Cosma et al., (2020); Chandra, (2020)	Confirmatory Factor Analysis: 1. Director's Educstion Background 2. Director's Work Experience
***Current Ratio* (Control)** Putra et al,, (2017)	$Control = -1\ x \frac{Current\ Assets}{Current\ Liabilities}$

3. RESULT AND DISCUSSION

Descriptive statistics

Tabel 2 Descriptive statistics

Varable	Obs	Mean	Std. dev	Min	Max
FD	108	-2,587	2,494	-11,834	3,503
ESG	108	0,218	0,209	0	0,899
FE	108	0,304	0,208	-0,336	0,413
*ESG**FE*	108	0,603	0,960	-3.635	3,811
CR	108	4,694	2,533	0,039	208,44

Source: Processed Data (2024)

Financial Distress is a disaster for every company because it indicates that the company will experience bankruptcy. Ripha & Muyassaroh, (2021) explain that bankruptcy occurs when a company experiences continuous financial difficulties over several periods. This is because the company is considered unable to pay off its obligations so it is threatened with ceasing operations. Based on Table 1 which presents the results of descriptive statistical tests which display statistical summaries for the variables tested to understand the basic characteristics of the data collected.

Table 1 presents the data distribution pertaining to all measurement variables. The FD variable is evaluated utilizing the Altman Z-Score x (-1) methodology. According to Fambudi et al. (2023), a higher numerical value denotes an enhanced financial standing. The dataset illustrates a minimum value of -11,834, ascribed to PT Ace Hardware Indonesia Tbk. in the year 2020, while the maximum value of 3,503 is associated with PT Sri Rejeki Isman Tbk. A company reflecting a minimum value signifies a robust financial position, whereas PT Sri Rejeki Isman Tbk. encounters notable financial challenges. The mean value stands at -2.587 with a standard deviation of 2.494, indicating a significant degree of variability in the data distribution relative to the mean.

When conducting assessments on Environmental, Social, and Governance (ESG) factors, a comparative analysis between disclosed elements and the total number of disclosure items can yield valuable insights. A minimum value of 0 signifies the absence of ESG item disclosures by a given company. In Indonesia, the voluntary nature of ESG disclosure underscores a dedication to environmental, social, and governance considerations (Fambudi et al., 2023). PT Intiland Development Tbk holds the highest value of 0.899, denoting the disclosure of 89.9% of ESG items in accordance with Global Reporting Initiative (GRI) standards, which are widely recognized for promoting transparency in sustainable reporting. The average ESG value is calculated at 0.218, indicating that only 21.8% of companies extensively disclosed ESG elements in the year 2020. The ESG variable demonstrates a normal distribution of data, with a standard deviation of 0.209, which is smaller than the average value.

The moderating variable, also known as the FE variable, exhibits a range between 0 and 1.651, with PT Duta Pertiwi Tbk registering the highest value within this spectrum. These moderating variables play a pivotal role in shaping the correlation between independent and dependent variables. The mean value attributed to this moderating variable stands at 0.304, accompanied by a standard deviation of 0.208, thereby indicating a distribution of data that adheres to normalcy. Noteworthy is the profitability value of CR, standing at 0.001, which is notably lower than the alpha 5%, underscoring a substantial adverse impact on Financial Distress. Current Ratio, a significant metric utilized to assess a company's financial well-being by gauging its capacity to meet imminent obligations, holds paramount importance. According to the findings of Ripha and Muyassaroh (2021), a company's susceptibility to bankruptcy may escalate if it grapples with fulfilling its obligations, hence rendering this ratio indispensable for investors keen on evaluating financial performance.

Multicollinearity Test

Tabel 2. Multicollinearity test result

Variable	VIF	1/VIF
ESG	2,94	0,340
FE	2,80	0,357
CR	1,09	0,919
Mean IVF	**2,28**	

Source: Processed Data (2024)

The conventional multicollinearity assumption test is commonly performed through regression analysis methods and statistical assessments such as VIF (Variance Inflation Factor) to evaluate the presence of multicollinearity in the regression model. The findings of the test reveal a VIF value < 10, suggesting that this model is free from multicollinearity.

Hypothesis Test Results

Tabel 3. Hypothesis test results

Variabel	Predict	Tanpa Moderasi			Dengan Moderasi		
FD	**-**	**Coefficient**	**z**	**P>[z]**	**Coefficient**	**z**	**P>[z]**
ESG	-	-3,434	-3,44	0,001	-3,609	-5,80	0,000

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FE	+	-	-	-	1,935	2,14	0,036
*ESG**FE	+	-	-	-	1,529	4,76	0,000
CR	-	-0,015	-1,14	-0,042	-0,015	-1,33	0,001
_Cons		-0,852	-5,42	0,000	-0,810	-6,13	0,000

FD_{t+1} = *Financial Distress, company i* year *t+1*

ESG_{it} = *ESG Score,* company *i* year *t*

***ESG_{it}**FE_{it}** = *ESG Score,* company *i* year *t* multiply *Financial Expert* company *i* year *t*

CR_{t+1} = *Current Ratio,* company *i* year *t+1*

Source: Processed Data (2024)

The probability value for the tested moderating variable is 0.000 with a coefficient of 1.529. The director's financial expertise as a moderating variable enhances the link between ESG disclosure and FD. This indicates that in cases where the company does not provide ESG disclosures and the director possesses financial expertise, the Financial Distress value decreases by -0.893. Moreover, each additional ESG disclosure reinforces the association between ESG and FD by 1.529. The Current Ratio serves as a pivotal financial metric utilized for evaluating a company's capacity to fulfill short-term obligations with its existing assets within a span of a year or less. A higher Current Ratio denotes a greater pool of assets available for settling long-term debts. Noteworthy research findings underscore the substantial impact of the Current Ratio variable on FD.

T-Test

The t-test plays a crucial role in determining the presence of a significant variance between the means of two distinct groups, aiding researchers in distinguishing genuine effects from random occurrences. Within the context of Table 5, the computed t value stands at 3.44, surpassing the designated t table value of 1.98. In the course of panel data regression analysis, the computed t values for the FE variable and the control variables stand at 4.76 and 1.33, respectively. Upon comparison with the t table, it becomes evident that the moderating variable exhibits a computed t value of 4.76, which exceeds the t table value of 1.98. Conversely, the Current Ratio variable showcases a computed t value of 1.33, falling short of the t table value of 1.98.

ESG Has a Positive Influence on Financial Distress

The research findings confidently show that ESG disclosure has a negative impact on Financial Distress. The number of companies disclosing ESG information is increasing annually. As of 2019, there were no official requirements for ESG disclosures in sustainable development. However, by 2022, the Indonesian Stock Exchange (BEI) will introduce an ESG index, making it mandatory for issuers to disclose ESG details. Notably, within the Consumer Cyclical sub-sector, there has been a significant rise in the number of listed companies disclosing ESG data. This increase in ESG disclosures is driven by companies' strong focus on sustainability. The trend continues to grow rapidly each year, showcasing the widespread adoption of sustainability strategies by businesses. In 2021, amidst the government's

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implementation of Large-Scale Social Restrictions regulations in Indonesia, companies actively sought new innovations to sustain their operations.

Construction projects have a significant impact on the environment, altering land, destroying natural habitats, increasing air and water pollution, and depleting natural resources. Environmental disclosure empowers companies to acknowledge these impacts and take decisive measures to mitigate them. This disclosure not only demonstrates corporate responsibility towards the environment but also showcases the company's unwavering commitment to sustainability. Companies with strong ESG disclosure practices diligently adhere to environmental, social, and governance regulations to uphold their credibility with stakeholders, including government, society, and investors. Investors perceive companies prioritizing ESG factors as having robust sustainability prospects. Through proactive risk management, these companies are recognized as reliable and adept at identifying potential hazards. Recent research by Citterio & King (2021) highlights that comprehensive ESG disclosure effectively mitigates risks, sending a positive signal to stakeholders by showcasing fair treatment and consideration of their long-term interests (Freeman, 1984).

ESG improvements in 2020 and 2021 confidently align with increased emphasis on FDs. Companies identify sustainability opportunities through ESG disclosures during a pandemic, prompting others to follow suit. This trend, reflecting Institutional Theory, asserts that ESG disclosure aligns with stakeholder pressure and corporate sustainability goals, shaping market dynamics and regulatory standards for environmental, social, and governance responsibilities. Companies entering this arena must confidently disclose ESG practices to establish credibility and demonstrate commitment. In 2020, despite ESG disclosures, Financial Distress values decreased for a Consumer Cyclical sub-sector firm. Consumer Cyclical companies are sensitive to economic cycles, with performance directly linked to consumer spending patterns. Compliance with Regulation NUMBER 2/POJK.04/2019 is crucial for firms to gain recognition for their ESG efforts. Good Corporate Governance (GCG) crucially hinges on prioritizing stakeholder rights to accurate information and transparent disclosure practices (Anggeline & Novita, 2020).

The Director's Financial Expertise strengthens the relationship between ESG disclosure and Financial Distress

Companies that possess a high number of directors with a strong background in finance have been shown to have a notable influence on Financial Distress through their ESG disclosures. The results of panel data analysis confirm the validation of hypothesis two, with a profitability value of 0.000 < α and a coefficient of 1.529. This signifies that the financial expertise of directors reinforces the connection between ESG disclosure and Financial Distress. These conclusions are in line with the research of Dionne et al. (2019), underscoring how the financial knowledge and academic qualifications of audit committee and board members shape a company's risk management strategies. According to Dionne et al. (2019), directors play a critical role in the company's risk management approach, underscoring the significance of their financial expertise in navigating risk exposure and management. Directors serve as intermediaries, facilitating transparent and efficient communication with stakeholders, which include shareholders, employees, customers, and the wider community. It is imperative for the Board of Directors to ensure transparent communication, clearly conveying the company's crisis response and its consequences. ESG disclosures in annual and sustainability reports serve as essential communication tools, outlining the company's strategies and future actions.

Companies within the Consumer Cyclical sub-sector derive significant advantages from the expertise of directors possessing robust financial acumen. Given the inherent financial volatilities stemming from economic oscillations and consumer trends, these entities greatly benefit from the guidance of directors well-versed in financial matters. Such individuals are instrumental in formulating adaptive strategies essential for navigating the aforementioned fluctuations. Moreover, they assume a pivotal role in shaping investment frameworks, encompassing the judicious allocation of capital towards growth initiatives. Effective engagement with stakeholders, notably investors and financial institutions, stands as a critical aspect for directors, facilitating the articulation of financial performance and strategic responses to business cycle dynamics. A profound comprehension of financial intricacies empowers directors to proficiently recognize and mitigate risks, particularly in periods of uncertainty, as exemplified by the ongoing pandemic. Through adept management of liquidity, mitigation of foreign currency risks, and proactive anticipation of market shifts, directors can bolster stakeholder confidence and trust.

In times of crisis, companies seeking funding can significantly enhance their prospects by engaging in ESG disclosures. Such firms are poised to experience decreased debt expenses in contrast to those abstaining from disclosing their ESG initiatives. The rationale behind this lies in the fact that ESG disclosures underscore corporate accountability, thereby fortifying competitive positioning and fostering trust in the organization's capacity to uphold operations amidst turbulent times. Furthermore, ESG disclosure functions as a clear conduit for companies to disseminate critical information to all stakeholders, facilitating robust oversight of corporate activities.

4. CONCLUSION

ESG disclosure has a beneficial effect on a company's financial well-being. Transparent communication of ESG practices can assist companies in averting financial difficulties, demonstrating accountability and dedication to stakeholders. Non-financial disclosures convey a favorable message to the public, bolstering societal perception and credibility. Statistical analysis indicates a noteworthy inverse correlation between ESG disclosure and financial distress, supported by a coefficient of -3.434 and a p-value of 0.000. Proficient ESG reporting enables companies to navigate away from financial hurdles effectively.

Directors' financial expertise plays a crucial role in strengthening the relationship between ESG disclosures and corporate Financial Distress. The Financial Expert variable, acting as a moderating factor, has been demonstrated to magnify the influence of ESG disclosure on Financial Distress. Financial Distress is a circumstance that falls outside the realm of directors' control. The analysis findings reveal a FE coefficient of 1.529 with a profitability of $0.000 < \alpha$, underscoring a significant reinforcement of the association between ESG disclosure and Financial Distress. The financial acumen of directors facilitates the comprehension of the importance of ESG disclosure in risk identification and sustainability evaluation. Companies stand to achieve substantial cost efficiencies through ESG disclosure practices, bolstering their resilience in times of global uncertainties and bolstering their societal reputation. This study serves as a valuable point of reference for companies looking to prioritize non-financial factors such as ESG disclosure, sending a positive signal to both companies and stakeholders.

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ESG research provides valuable insights for stakeholders seeking to understand the impact of ESG disclosures on Financial Distress. Future research endeavors could expand their focus by examining ESG disclosure practices in companies, distinguishing between those that comply with mandatory and voluntary ESG standards.

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