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Consistent Environmental Performance: Does It Matter for Achieving Good Financial Performance?

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Abstract

This study examines the impact of environmental performance on financial performance in Indonesia. To improve the prior results, this study focuses on companies that consistently achieve good environmental performance and those who do not consistently obtain good performance. The environmental performance measured by environmental ratings that published through a PROPER Program, while the financial performance is measured by return on assets, earning per share, and Tobin's q. Some control variables included in this study such as firm age, firm size, leverage, and market share. The study finds that environmental performance is positive significantly associated with financial performance for the companies that consistently record a good environmental performance. The more consistent the company's performance in environmental, the higher the association with the financial performance.

Keywords: Environmental Performance, Financial Performance, PROPER

1. Introduction

Prior studies on the impact of environmental performance on financial performance that showed various results (Qi et al., 2014; Sarumpaet et al., 2017). Can environmental performance increase financial performance? Is going green cost worth with the return that the company gets in the future? Some studies argue that doing environmental performance cost more than the return that they got, but some researcher assumed that market appreciates green companies. Finally, environmental performance will increase financial performance indirectly (Sarumpaet, 2005).

The studies on the impact of environmental performance and financial performance are still inconclusive. Some of the studies found that there are significant and positive association of environmental performance and firm performance (Al-Tuwaijri, et al, 2004; Suratno, et al, 2006; Arafat et al, 2012; Alvarez et al, 2015; Vafeas & Nikolaou, 2015; Misani & Pogutz, 2015; Li, et al, 2017; Manrique, et al, 2017; Sarumpaet, et al, 2017), but the others showed insignificant results (Rockness et al., 1986; Sarumpaet, 2005; Almilia & Wijayanto, 2007; Earnhart & Lizal, 2007; Iwata & Okada, 2011; Liang & Liu, 2016). Several studies even find the negative impact of environmental performance and financial performance (Rahmawati & Ahmad, 2012; Vastola et al., 2016). Most of the previous studies are conducted in some developed countries such as the USA and Japan, where people lived in a high awareness of environmental issues.

Studies on environmental issues in developing countries become interesting since the awareness of people in developing countries on this issue tends to become increasing. In Indonesia as one of developing countries, the

Government has a big concern about this issue. Through the Environment Ministry, the Government of Indonesia conducted a national extensive environmental performance valuation that called PROPER (Sarumpaet, 2005).

The Indonesian Government released PROPER ratings published by the Indonesian Ministry of Environment. This rating is believed to have a reliable indicator since it is published annually so that it can reduce information asymmetry. PROPER ratings are used to describe each company's environmental performance from best to worst, i.e., gold, green, blue, red and black (Sarumpaet et al., 2017).

The concern of companies to the environmental issues should be paid by the high firm performance, as the argumentation of Stakeholders Theory. According to this theory, if the company fulfill the needs of stakeholder both economic and non-economic, they will get support from the stakeholder. Performance in environmental responsibility will improve the company's image & reputation, get more loyal customer and increase share price (Heinkel et al., 2001; Prisch et al., 2007; Guenster et al., 2011).

The contradictive of the previous results open the venue for the current study; therefore, the purpose of this study is to add the evidence on the impact of environmental performance on financial performance from the developing country. To improve the results, this study split the sample into two groups, the first group is the companies that consistently achieve good performance and the second group is the companies with consistent poor environmental performance. Consistency in environmental performance will enable the company to continue it is operating and keep the trust from the stakeholders (Misani and Pogutz, 2015; Vafeas & Nikolaou, 2015). Companies that have high environmental performance will also have high financial performance while companies with low environmental performance will also have low financial performance. PROPER is used to measure the environmental performance and return on asset, earning per share and Tobin's q is used to measure the financial performance.

2. Literature Review

Environmental performance is the performance of the company in protecting and preserving a suitable environment (Suratno et al. 2006). Ikhsan (2008) argues that environmental performance is an activity carried out by the companies that related to the surrounding natural environment. In Indonesia, the rules regarding environmental performance are regulated in the regulations of the environment minister number 6 in 2003 which says "The program for rating the performance of companies in environmental management referred to as PROPER, is a research program on the efforts of those responsible for businesses and activities in controlling pollution and environmental damage or management of hazardous and toxic materials. The purpose of this program is to make companies to be more concerned with the needs of stakeholders and to encourage companies to be better manage their environmental performance and their responsibility.

Environmental responsibility is a form of organizational obligation that not only provides goods and services for the community but also participates in maintaining environmental quality and contributing positively to the community (Januarti and Apriyanti, 2006). Companies that have environmental responsibility can avoid claims from the public and the government so that it will improve product quality which will ultimately increase economic benefits (Porter and Linde, 1995). According to stakeholders theory, there is a relationship between a company which concerns environmental performance and financial performance.

According to Sari (2012), companies are not only responsible to stakeholders but shifting to be broader namely to arrive at the social (stakeholder) domain by taking into account factors social dimension. The relationship between environmental performance and financial performance in the theory of stakeholders, stating that the company must take direct action into stakeholders (shareholders, customers, investors) and indirect stakeholders (community, society).

Financial performance is the result obtained by the company due to carrying out various activities in using the resources they have. Financial performance can be seen through financial statement analysis and financial ratio analysis (Husnan, 2005). Susanto and Tarigan (2013) argue that financial performance is a result of decisions

obtained based on an assessment of the ability of a company, both regarding profitability, liquidity, activity, and solvency. Horngren & Harisson (1993) argue that financial performance is useful for measuring company performance and management of a business where financial performance is a tool for management that is useful in controlling a company.

Previous studies on environmental performance or reporting have used different measures of financial or economic performance. For example, Bragdon and Marlin (1972) used accounting-based measures that are earning per share and return on equity; while Spicer (1978) used both accounting-based and market-based measures, i.e., profitability and the price-earnings ratio). This study uses Earning Per Share (EPS), Return on Assets (ROA) and Tobin's Q as the financial performance measurement. EPS is net income that is ready to be shared with shareholders divided by the number of shares of the company (Tandelilin, 2010). The following formula calculates EPS:

$$EPS = \frac{Earning\ After\ Tax}{Shareholders\ Outstanding} \tag{1}$$

Return on Assets ratio that shows the company's ability to use the number of assets it has to generate profits in a period (Almilia et al., 2009). According to Rachmithasari (2015), return on assets can be measured by using the formula for net income after tax divided by total assets.

$$ROA = \frac{Net\ Income}{TOtal\ Asset} \tag{2}$$

Tobin's Q measures the company's financial performance concerning potential market value, and Tobin's Q is more directed at investment growth potential. Mathematically Tobin's Q can be calculated by formulating the formula as follows Lindenberg & Ross (1981):

$$Tobin's\ Q = \frac{Market\ Cap + Debt}{Total\ Asset} \tag{3}$$

2.1 Hypothesis Development

Companies do not just have to focus on shareholders but also must focus on the stakeholder (Ferner and Quintanilla 1998). Besides that, the success and sustainability of a company are in the hands of stakeholders, by maintaining the support from stakeholders. The commitment of companies to protecting and preserving the environment is one of the ways to get support from the stakeholders (Prisch et al., 2007; Li et al., 2017). Muhammad et al., (2015) showed that there was a significant influence impact of the company's environmental performance on the company's financial performance. Coopers and Lybrand (1993) argue that company with excellent environmental performance can get trust from society and make the company have a better financial performance. The company should be concerned with not only short-term profit but also the long-term profit by attracting the stakeholder interest (Li et al. 2017). The company with excellent environmental performance does not only disclose the company concern for the environment but also about product quality, product safety, corporate social responsibility towards the surrounding community, and the company concern for the safety and employee prosperity (Rakhiemah and Agustia, 2009). Verrecchia (1983) argues that a company with good environment reveal good news for the stakeholder to invest in that company better than other competitors. Suratno, et al., (2006) argue that good news is essential to company and stakeholder for the future company operating to improve financial performance and have more valuable company than others. Based on the above explanation, the hypothesis is as follow.

H_1: Environmental Performance has a significant positive effect on Financial Performance

Some of the previous studies indicate that environmental performance has insignificant or even negative effect on financial performance. However, some researchers have successfully found the consistent results on the on the association between environmental performance and financial performance, Vafeas & Nikolaou (2015),

Sarumpaet, et al., (2017) and Misani and Pogutz (2015). Sarumpaet et al., (2017) found a positive relationship between PROPER and the stock price when dividing the sample into the ratings of "Good" and "Poor", but found no influence when using all sample data without dividing it. Misani and Pogutz (2015) argue that companies that have high environmental performance will also have high financial performance while companies with low environmental performance will also have low financial performance. Consistency in environmental performance will enable the company to continue it is operating and keep the trust from the stakeholders. Following Vafeas & Nikolaou (2015) that prove the consistent results this study divide sample into two groups. The first groups are the companies that consistently get an excellent PROPER ranking (Gold, Green, and Blue) and the second group is the companies that consistently records the poor rating (Red and Black). When the company consistently contribute to environmental performance, it will contribute to the significant positive effect on financial performance.

H_2: Companies that consistently receive good environmental performance have positive financial performance compared to those who do not have consistent environmental performance

3. Research Method

3.1 Sample

This study is applied to listed firms in Indonesia Stock Exchange (IDX) and participated in the PROPER Program for the period of 2010 to 2017. Companies that have information that needed for this study will directly exclude from the sample. After strong selection for the completeness of the data, the sample of this study are 48 companies that come from 8, and that will make total observation around 384 firm-year observation. In table 3.1 explained in the sample selection to 48 companies and made the data of this study to be 384. Data are collected from Bloomberg; meanwhile, for the company's annual environmental performance are gathered from the website of the Indonesia Ministry of Environment

Table 3.1 Sample selection output

Sample Requirement	The amount of observation
The company that listed in BEI	626
Incomplete data	(182)
Companies that do not enter in PROPER Program from 2010 to 2017	(396)
Total company	48
Total Observations	**384**

3.2 Variables Operationalization

Financial performance is measured by return on assets (ROA), earning per share (EPS), and Tobin's Q. Return on asset is measured by earning after tax divided by total asset (Rachmistasari, 2015). Return on asset is a critical component to show how well a company deals with the asset to generate profit in a period (Almilia et al., 2009). Earnings per share are measured by earning after interest and tax divided by total outstanding share (Tandelilin, 2010). Earnings per share are as an indicator of company sustainability in the future, the stable value of earning per share as a positive signal to companies sustainability (Young, 2002; Kasmir, 2008). Tobin's Q is measured by Total

Debt plus market value of all outstanding stock (MVS) are divided by the total asset. MVS is closing price multiplied with the outstanding share (Lindenberg & Ross, 1981). Tobin's Q is an investor perception towards company about their share price. The high price of the share will also increase the value of the company (Brealey et al., 2007). PROPER ratings measure environmental performance. This rating is divided into five color ranks which are gold for the best, and then green, blue, red, and black for the worst (Indonesia Ministry of Environment, 2015).

Gold was given to the company that consistently show the excellence of environment in the production process or service process. Green was given to the company that does the environmental management better than the applicable law. Blue was given to the company that does the environmental management following applicable law. Red was given to the company that does environmental management, but their effort is below the standard of the applicable law; meanwhile, Black was given to the company that intentionally break the law that was given that can make serious effect that will harm the environment, black was also given to the company that violates the rule and ignore the administration fine that given to them.

To increase focus on our study, we use some control variables which are firm size, firm age, leverage, and market share. Firm Size is measured by the logarithm of the total asset of the company (Johnson and Greening, 1999; Ball and Foster, 1982; Dechow and Dichev, 2002). Firm age is measured by the logarithm of the total years of the companies since listed in IDX (Chun *et al.*, 2008). Leverage is measured by the ratio of total debt divided by total equity (Weston and Copeland, 2012). Debt to equity ratio (DER) informs a company equity structure to help investors to assess the company's risk (Husnan and Pudjiastuti, 2002). Market share is measured by a ratio of total company sales divided by total industry sales (O' Regan, 2002).

3.3 The Model of Analysis

The study uses multiple ordinary least squares regression model to test the hypothesis. The following is the model of analysis

$$\text{FP}_{i,t} = \alpha + \beta_1 \text{PROPER}_{i,t-1} + \beta_2 \text{PROPCONS}_{i,t-1} + \beta_3 \text{LEV}_{i,t-1} + \beta_4 \text{FSIZE}_{i,t-1} + \beta_5 \text{FAGE}_{i,t-1} + \beta_6 \text{MSHARE}_{i,t-1} + \mathcal{E} \tag{4}$$

Where:

$Q_{i,}$ t: Tobin's Q of company $_i$ at year $_t$

$FP_{i,}$ t: Firm performance of company $_i$ at year $_{t-1}$, measured by ROA, EPS and Tobin's Q

$PROPER_{i,}$ t: PROPER rank of company $_i$ at year $_{t-1}$

$PROPCONS_{i,}$ t: Dummy variable for the consistency of the PROPER rank of company $_i$ at year $_{t-1}$

$LEV_{i,}$ t: Leverage of company $_i$ at year $_{t-1}$

$FSIZE_{i,}$ t: Firm size of company $_i$ at year $_{t-1}$

$FAGE_{i,t}$: Firm age of company $_i$ at year $_{t-1}$

$MSHARE_{i,}$ t: Market Share of company $_i$ at year $_{t-1}$

4. Result and Discussion

Table 4.1 shows the descriptive statistic for the full sample. Companies that accomplish good PROPER rating consistently show different characteristics from companies that get good PROPER rating inconsistently. The market share, firm size, and firm age inconsistent group, on average is smaller than the other one, except leverage. The financial performance of companies that achieve good PROPER rating consistently is better than inconsistently get a good PROPER rating. The PROPER inconsistent group is higher than the inconsistent group, this is indicated by the mean of the PROPER inconsistent group is 3.29, and the inconsistent group is 2.95.

Table 4.1. Descriptive Statistic for the Full Sample

Variable	All Sample	Inconsistent PROPER	Consistent PROPER
ROA			
Mean	0.0677	0.0538	0.0817
std dev	0.106	0.0870	0.122
EPS			
Mean	265	224	305
std dev	655	657	652
Tobin's Q			
Mean	1.96	1.5	2.42
std dev	2.59	1.13	3.42
PROPER			
Mean	3.12	2.95	3.29
std dev	0.438	0.379	0.426
MSHARE			
Mean	2.06	2.16	1.96
std dev	1.9	2.23	1.49
FSIZE			
Mean	12.9	13	12.9
std dev	0.574	0.622	0.521
AGE			
Mean	1.2	1.27	1.14
std dev	0.264	0.18	0.315
LEV			
Mean	0.408	0.26	0.556
std dev	2.89	3.9	1.2
Observation	384	192	192

Table 4.2 shows that PROPER do not have significant effect to return on asset (p-value= 0.3412) and Tobin's q (p-value= 0.2843), but have significant negative effect to earning per share (p-value= 0.0196). It seems that the increase in PROPER can cause a decrease in earning per share. However, after dividing the sample into two groups, we find that PROPCONS has positive significant effect to return on asset (p-value= 0.0235), earning per share (p-value= 0.0278), and Tobin's q (p-value= 0.0007). These findings show that consistent good environmental performance has a significant impact on firm performance. This result is in line with stakeholder theory and previous research (Sarumpaet et al., 2017).

The company that has consistent good environmental performance will have a competitive advantage, that can be translated into better financial performance (Al-Tuwaijri et al., 2004; Sarumpaet et al., 2017). Good environmental performance leads to a positive market response, building good relations with stakeholder especially primary stakeholder, that finally create a competitive advantage (Hillman & Klein, 2001).

Table 4.2 The Results of Hypothesis Testing

Variables	Return on Asset		Earnings per Share		Tobin's Q	
	Coefficients	*p*-value	Coefficients	*p*-value	Coefficients	*p*-value
Const	0.2462.85	0.1322	−4872.53	<0.0001***	6.4689.2	0.0874*
PROPER	0.0130.289	0.3412	−195.503	0.0196**	0.3389.40	0.2843
PROPCONS	0.0269.166	0.0235**	159.423	0.0278**	0.9313.10	0.0007***
MSHARE	0.0152.797	0.0001***	−37.3272	0.1180	0.4500.07	<0.0001***
FSIZE	−0.0208.091	0.1126	466.218	<0.0001***	−0.5547.58	0.0675*
FAGE	0.0352.151	0.0852*	−66.4276	0.5939	1.2543.0	0.0082***
LEV	−0.0003.1642.7	0.8611	0.931235	0.9327	−0.0111.858	0.7891
IDSector	−0.0115.410	0.0001***	−63.6745	0.0006***	−0.3983.80	<0.0001***

Notes: *, * * and * * * denote statistical significance at the 10%, 5% or 1% level.

Good environmental performance will lead to being better environmental reputation, improve company's image, increase loyal customer, and reduce unnecessary costs like workers or society demonstrate on (Heinkel et al., 2001; Cai & He, 2014). Environmental performance is an investment, where the benefit cannot be expected in the short-term but long-term (Wong et al., 2016). The result is in line with stakeholder theory which states that if a company fulfill the needs of stakeholder both economic and non-economic needs, the company will get support from stakeholder like a more loyal customer, improve brand image, increase the share price, and financial performance (Crisóstomo, Freire, & Vasconcellos, 2011). The results explain the inconsistent results of the previous research in environmental performance and financial performance. The firm determination to maintain good environmental performance will have a positive impact on financial performance information.

The findings of this study support that the concern of the Government of Indonesia to encourage companies to be responsible for their environmental impact produce good results. The restricted regulation on the environmental impact matter since it can save the stakeholders' interest and prevent a potential violation of the environmental responsibility. The company that disobeyed the rule must be punished based on the regulation. Stakeholders appreciate to the company that consistently have a good ranking of environmental performance. Their role is essential in motivating companies to keep good performance in the environmental aspect. Therefore, there is a payoff for the consistently good performance and vice versa.

Some control variables show as the determinant of the firm performance, MSHARE has positive significant effect to both return on asset (*p*-value= 0.0001) and Tobin's Q (*p*-value= 0.0001), FSIZE has significant effect to both earning per share that has *p*-value= 0.0001; coef= 466.22 and Tobin's Q that has *p*-value= 0.0001; coef= -0.54. FAGE has positive significant effect to return on asset (*p*-value= 0.0852) and Tobin's Q (*p*-value= 0.0082), however, LEV has no significant impact on financial performance. A company that has high market share, it means that the company can fulfill market demands and most of the consumers like that company's products. Because of that, the company will get more profit and increase financial performance. Companies that have a high market share also indicate that the company has a good image in the perspective of a stakeholder. Financial performance is also explained by firm size. Big companies usually have more stable in operations, have a competitive advantage that small companies and have a good reputation in stakeholder's perspective. The big companies are trusted by the stakeholder that it has a better future. Company's age shows the experience of the company in running their business Age of company is one of the components of company success. This makes more experienced companies more trusted by the market. Leverage should be a positive impact towards financial performance because the higher debt that owned by the company can maximize the profit and operations. However, hypothesis testing shows the opposite result.

5. Conclusion

This study examines whether environmental performance will be followed by good financial performance, especially for the consistent good performer. The results support that the consistency of the companies to keep good environmental performance resulting in good financial performance. We find that the group of firms that consistently have a good environmental performance achieve good financial performance and vice versa. This finding can explain the inconsistent results of prior studies. It confirms that environmental information is needed to inform stakeholder that the companies made a better contribution to the environmental issues.

There are some limitations to this study. First, we fail to include all the companies participate in the PROPER Program since many companies are not listed in Indonesia Stock Exchange so that data are not available. Second, our results should be carefully generalized, since it is only applicable to the listed companies. Future research is still needed to convince the companies the benefit of involving in PROPER and environmental issues, as well.

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