ESG Performance during Financial Performance and Reporting Quality Shortfalls: Proving Signaling Theory in Indonesia

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Abstract

This study aims to examine the inverse relationship between financial performance shortfalls and corporate ESG performance to determine whether companies exploit biases that can be created by using corporate ESG performance as a signaling mechanism. The sample of this study consists of companies listed on the Indonesia Stock Exchange from 2000 to 2023. The final sample includes 450 company-year observations. The results of this study indicate that there is a negative correlation between the decline in short-term financial performance and the company's ESG performance. In addition, corporate stakeholders in developing countries, such as Indonesia, still lack confidence and trust in company's environmental, social, and governance (ESG) strategies, which contributes to the less effective performance of ESG as a signaling mechanism for companies in Indonesia. In addition to contributing to investor decision-making processes focused on issues related to corporate environmental and social sustainability, the results of this study are also expected to help investors and regulators understand environmental, social, and governance (ESG) activity patterns when companies face financial performance shortfalls. Finally, this study provides theoretical validation of signaling theory in the context of developing countries, specifically Indonesia.

Abstrak

Penelitian ini bertujuan untuk menguji pengaruh terbalik antara kekurangan kinerja keuangan dan kinerja ESG perusahaan, untuk mengetahui apakah perusahaan mengeksploitasi bias yang dapat diciptakan dengan menggunakan ESG kinerja perusahaan sebagai mekanisme pensinyalan. Sampel penelitian terdiri dari perusahaan yang terdaftar di Bursa Efek Indonesia dari tahun 2000 hingga 2023. Sampel akhir penelitian terdiri dari 450 observasi tahun perusahaan. Kami menemukan korelasi negatif antara penurunan kinerja keuangan jangka pendek dan kinerja ESG perusahaan. Kami menemukan bahwa pemangku kepentingan perusahaan di negara-negara berkembang seperti Indonesia masih belum memiliki keyakinan dan kepercayaan pada strategi lingkungan, sosial, dan tata kelola perusahaan, yang memengaruhi kinerja ESG yang kurang efektif sebagai mekanisme pensinyalan untuk sampel perusahaan di Indonesia. Temuan penelitian ini berkontribusi pada proses pengambilan keputusan investor yang berfokus pada isu-isu yang terkait dengan kegiatan keberlanjutan lingkungan dan sosial perusahaan. Penelitian ini membantu investor dan regulator dalam memahami pola kegiatan lingkungan, sosial, dan tata kelola (ESG) ketika perusahaan menghadapi penurunan kinerja keuangan. Akhirnya, penelitian ini memberikan validasi teoritis terhadap teori pensinyalan dalam konteks negara berkembang, yaitu Indonesia.

1. Introduction

In general, companies will take steps to formulate new strategies when facing an unexpected decline in financial performance. In such situations, companies may take action by increasing investment (Sumiyana, Na'im, et al., 2023) and conducting research and development activities (Shinkle, 2011), which implies a higher corporate risk-taking propensity (Peng & Isa, 2020; Toth et al., 2021). Previous research shows that companies tend to increase investment and R&D when their financial performance is below expected levels (Shinkle, 2011; Sumiyana, Na'im, et al., 2023; Taj, 2016). In the short term, increased investment and R&D activities can create opportunity costs that lead to a decline in firm operational performance (Dalziel et al., 2011; DasGupta, 2022; Gavetti et al., 2012).

On the other hand, in a financial downturn, companies can gain significant leverage by taking actions perceived as positive (Huang, 2022; Sumiyana, Na'im, et al., 2023). Related to asymmetric information (Spence, 2002), companies have an incentive to communicate positive information to present a positive image of the company's condition through environmental, social, and governance activities (Huang, 2022). This is supported by empirical studies that document the relationship between corporate ESG performance and corporate financial performance (Ahmad et al., 2021; Koundouri et al., 2021; Velte, 2017; Xie et al., 2018). The results of research conducted by Ahmad et al. (2021) show that a company's ESG performance has a positive effect on market value and earnings per share, both statistically and dynamically. Research conducted by Koundouri et al. (2021) shows a tendency for lower beta coefficients in European companies with strong ESG performance. The results of research conducted by Velte (2017) indicate that the three main components of ESG (environmental, social, and governance) have a positive effect on corporate accounting profitability, with governance aspects having the most substantial effect. Meanwhile, the results of research conducted by Xie et al. (2018) show that moderate ESG disclosure rates have a positive effect on company efficiency. Referring to previous research, corporate ESG performance can be used as a signal that appears to describe the characteristics and financial performance of a company, potentially creating bias in judging the company's actual performance (DasGupta, 2022; Huang, 2022; Osagie et al., 2016; Xie et al., 2018). In this case, information asymmetry causes disturbances in the information structure between the company and stakeholders, which exacerbates ESG performance, due to the possibility of different interpretations by each stakeholder of the company (Cho et al., 2015; Peng & Isa, 2020).

Specifically, this study aims to examines the inverse relationship between corporate ESG performance and declining financial performance to determine whether companies exploit biases that can be created by using corporate ESG performance as a signaling mechanism. The sample of this study is companies listed on the Indonesian stock exchange from 2000 to 2022. This study uses the Thomson Reuters ASSET4 environmental, social, and governance pillar performance platform scores to measure the environmental and social performance of companies as dependent variables (DasGupta, 2022; Shi & Veenstra, 2020). To measure the financial performance shortfall, this study uses a proxy of the level of historical aspirations and corporate social aspirations (Bromiley & Harris, 2014; Lucas et al., 2015). The social aspiration level of a company is calculated based on the average financial performance and the average quality of the five-year cross-sectional financial reporting (excluding the focus company) for each industry cluster (DasGupta, 2022; Peng & Isa, 2020; Putri et al., 2024). The historical level of the company's aspiration is calculated by comparing the financial performance gap and the quality difference between the financial reports of the current year and the actual performance of the firm in the previous year (DasGupta & Dhochak, 2021; Shinkle, 2011).

Many studies have examined the relationship between ESG performance and financial decline, but the results remain disparate, necessitating a review in three key areas. First, most previous studies focus on developed markets, where companies have implemented ESG obligations that are firmly integrated into their business and investment processes (DasGupta, 2022; Naeem et al., 2022; Velte, 2017). This study offers a new perspective by considering the characteristics of developing countries, such as Indonesia, which have different institutional structures and stakeholder expectations. Second, the role of ESG implementation within companies as a reactive signaling mechanism during financial performance declines has not been explored, particularly regarding whether companies intentionally use ESG as a tool to disguise or compensate for poor financial results. Third, few studies disaggregate ESG components to examine how environmental, social, and governance dimensions respond differently to financial distress. This study aims to fill this gap in previous research by investigating the role of ESG performance signals in the Indonesian context by using company data from 2000 to 2023, disaggregating ESG into its core components, and incorporating industry benchmarks and historical performance.

This study contributes to the theoretical approach to the use of signaling theory in the context of developing countries. Specifically, signaling theory does not provide significant signaling of corporate performance through a decline in financial conditions and the company's financial condition on ESG performance in Indonesia (Bromiley & Harris, 2014; Lucas et al., 2015; Putri et al., 2024). The findings of the study indicate that, despite a decline in financial conditions, ESG performance increased significantly. This means that ESG remains a point of fulfillment for legal and social obligations that are not directly correlated with the decline in the company's financial condition. Second, this study contributes to the perspective of practice for investors and regulators to understand the company's condition better. The findings in this study demonstrate that the prospective ESG in developing countries remains highly dependent on the company's financial condition (Ahmad et al., 2021; Koundouri et al., 2021; Velte, 2017; Xie et al., 2018). So, ESG is not a significant component of the company's commitment, but rather is limited to fulfilling obligations based on the company's profit orientation.

This study is further structured as follows: Section 2 explains the development of the theory, literature review and hypothesis development. Section 3 explains the methodology, including research samples, variable measurement, and hypothesis testing. Section 4 explains the results of descriptive statistical testing, hypothesis testing, and discussion. The last section explains the conclusions and limitations of the study.

2. Theoretical Background, Literature Review, and Hypothesis Development

2.1. Signaling Theory

Signaling theory primarily aims to mitigate information asymmetry between companies and their stakeholders (Bae et al., 2018). Companies typically have a habit of communicating positive information about the company's condition to stakeholders, aiming to reduce information asymmetry and preserve the company's reputation (Connelly et al., 2010). However, in an asymmetric information environment, companies tend to flood stakeholder with positive information that can be expected to be an indicator of the quality assessment of a company (Spence, 1978, 2002), which can ultimately cause disturbances in the information structure between the company and stakeholder (Cho et al., 2015; Connelly et al., 2010). Based on the signaling theory perspective, companies can use both positive and negative information as an illustrative mechanism that can change paradigms previously held by stakeholders (Yasar et al., 2020).

Signaling theory comprises four main elements: the signaler, the signal, the receiver, and the feedback, which align with the basic communication pattern (Connelly et al., 2010; Taj, 2016). From the perspective of a business organization, a signaler is a person within the organization (typically a manager or executive) who possesses detailed information about individuals, organizational operations (Ross, 1977), and products (Bergh et al., 2014) that is unknown to external parties (Taj, 2016). Signals are the flow of information sent from one party to another to affect a specific desired outcome (Connelly et al., 2010; Taj, 2016). Signal recipients are generally those outside the company who have organizational information restrictions in detail (Connelly et al., 2010; Taj, 2016). Meanwhile, feedback reflects the interaction that occurs between the signal provider and the signal recipient (Connelly et al., 2010; Taj, 2016). Organizational strategic decisions serve as signals to the market regarding commitments and initiatives that impact the organization's reputation and relationships with various stakeholders (Ching & Gerab, 2017; Mavlanova et al., 2012; Putri et al., 2024). Positive signals in this case can improve the value and performance of the company, while negative signals can affect the judgment and perspective of stakeholders towards the company (Bae et al., 2018).

2.2. Financial performance decline and ESG performance

By referring to the concept of signaling theory, companies can utilize environmental, social, and corporate governance activities as a signal that may lead to information bias among stakeholders, due to potential differences in interpretation (Cho et al., 2015; Connelly et al., 2010). The concept of Signaling theory provides an opportunity for companies to reconcile symbolic values (Huang, 2021; Toth et al., 2021), which encourages companies to exploit information gaps by providing specified and unique signals as illustrative mechanisms (Bergh et al., 2014; Kurniawan et al., 2022; Toth et al., 2021), in the hope of changing the perception of corporate stakeholders (Huang, 2022; Kurniawan et al., 2024; Yasar et al., 2020). In this case, environmental, social, and governance (ESG) performance can be used as a signal that appears to describe the main characteristics and performance of a company, thereby potentially biasing the assessment of the company's actual performance (DasGupta, 2022; Huang, 2022; Osagie et al., 2016). Signaling theory suggests that effective corporate management uses environmental, social, and governance activities to send a signal to stakeholders regarding corporate commitments and long-term sustainability-oriented policies (Bae et al., 2018; Ching & Gerab, 2017; Connelly et al., 2010).

This study addresses the characteristics of developing countries. According to Visser (2008), developing countries tend to focus more on accelerating economic growth, thus avoiding activities that prioritize environmental and social issues. Furthermore, weak regulations encourage voluntary ESG implementation, with minimal pressure to implement it (Naeem et al., 2022; Naimy et al., 2021). This voluntary disclosure is further complicated by limited infrastructure, inadequate human resources, and a lack of understanding of the importance of ESG disclosure (Koundouri et al., 2021; Naeem et al., 2022). Ultimately, developing countries offer an interesting institutional backdrop for a more in-depth examination of ESG performance disclosures when financial reporting performance declines.

Environmental, social and governance activities can be a signaling mechanism that reveals additional information to stakeholders, including in developing countries, although the relationship between environmental, social and governance activities and a company's financial performance remains controversial and debated (Karnani, 2011; Kurniawan et al., 2022; Rivoli & Waddock, 2011; Su et al., 2014). In developing countries, environmental, social and governance activities can be seen as a mechanism for companies to fill institutional gaps caused by weak state regulations on corruption, law enforcement, and social services (Jamali & Karam, 2018; Kurniawan et al., 2024; Osagie et al., 2016; Su et al., 2014). Companies that engage in environmental, social, and governance (ESG) activities provide investors with signals that differentiate them from their competitors, enabling investors to make more informed judgments about the company (Doh et al., 2009; Lee, 2016; Paulraj, 2011).

When financial performance declines, companies will come under greater scrutiny from stakeholders regarding their strategic direction and long-term sustainability (Flammer, 2013; Jamali & Karam, 2018; Lys et al., 2015). By increasing environmental, social, and governance (ESG) activities during periods of declining performance, companies can signal a strategic orientation that helps enhance their reputation (Eccles et al., 2014; Lys et al., 2015). Good environmental, social, and governance performance amid falling corporate financial performance conditions can be a sign of corporate resilience and the effectiveness of risk management practices, thus becoming a positive signal that can convince stakeholders and maintain their confidence in the company's performance prospects (Cheng et al., 2013; Flammer, 2013). Increased corporate initiative in environmental, social, and governance (ESG) activities can be viewed as a form of investment in sustaining long-term competitiveness and focusing on corporate value creation, which signals potential for improved financial performance in the future (Flammer, 2013; Lys et al., 2015). On the other hand, corporate initiatives in environmental, social, and governance (ESG) activities, particularly during a period of declining financial performance, demonstrate the company's commitment to creating shared value for all corporate stakeholders (Ferrell et al., 2016). The hypothesis in this study is structured as follows:

H1: Financial shorfall has a positive effect on ESG performance.

3. Research Method

3.1. Research data and sample

The sample of this consists of companies listed on the Indonesian Stock Exchange from 2000 to 2023. This study uses a purposive sampling method with several criteria. First, this study covers all companies listed on the Indonesia Stock Exchange from 2000 to 2023. All companies are considered because they are required to implement ESG practices for all types of companies. Second, this study focuses on companies that publish financial reports with a fiscal year-end of December 31. Sample selection for hypothesis testing is based on criteria such as the availability of environmental, social, and governance performance data from Thomson Reuters' ASSET4 (DasGupta, 2022; Shi & Veenstra, 2020), as well as corporate financial performance data (DasGupta, 2022; Shi & Veenstra, 2020). The final sample of this study consists of 450 company-year observations. This study utilizes the Bureau Van Dijk database (OSIRIS) to obtain company-specific data from 2000 to 2023, and the Thomson Reuters database to obtain environmental, social, and corporate governance performance data. Researchers argue that the use of periods will reflect the long-term trends of topics in ESG (Su et al., 2014; Velte, 2017) and the relevance of ESG constructs that require a long time to see their impact (Cheng et al., 2013; DasGupta, 2022; Doh et al., 2009).

3.2. Calculation of financial performance decline

To calculate the variable of financial performance decline, this study develops a measurement of the level of aspirations based on the company's historical performance (Bromiley & Harris, 2014; Lucas et al., 2015). The company's historical aspiration performance in this study is based on a comparison between the company's financial performance in the current year and the financial performance of the previous year (DasGupta & Dhochak, 2021). The financial performance of a company is measured using the Altman Z-score value (Altman, 2005), which captures the characteristics of liquidity (X1), profitability (X2), operational efficiency (X3), and leverage (X4) of the company. Measurement of corporate financial performance as the basis for calculating financial performance decline is as follows:

$$\text{Z-Score} = 3.25 + 6.56*X1 + 3.26*X2 + 6.72*X3 + 1.05*X4 \quad (1)$$

Where Liquidity is acquired through working capital divided by total assets, profitability is gained through retained earnings divided by total assets. Operating efficiency is gained by operating income divided by total assets. Leverage is gained via the book value of equity divided by total liabilities of the company. Financial performance shortfall indicates a negative difference in a company's financial performance compared to its historical value and that of its industry sector. A value of 1 indicates that the company has a negative financial performance difference, while a value of 0 indicates the opposite.

3.3. Hypothesis testing model

This study employs a generalized least squares regression model (GLS) to test the first hypothesis, as shown in equation (2). The dependent variables in this study consist of the financial performance shortfall ($FPS_{i,t}$) and the financial reporting quality shortfall ($FRQS_{i,t}$) which are measured using the level of social aspirations and the historical aspirations of the company. The independent variable used in this study is environmental, social, and governance performance ($ESGP_{i,t}$). This study controls the characteristics of sample companies by using several variables. such as company size ($SIZE_{i,t}$), asset growth ($GWH_{i,t}$), liquidity ratio ($LR_{i,t}$), sales rate ($STURN_{i,t}$), property ratio, factory and equipment ($PPER_{i,t}$), and intangible asset ratio ($INTR_{i,t}$). This study acknowledges the potential for endogeneity, particularly due to the reverse causality between declining financial performance and ESG performance. To mitigate this risk, the study uses the Generalized Least Squares (GLS) estimation method. GLS is suitable for panel data and can correct for heteroscedasticity and autocorrelation, which are common characteristics of firm-level time series data (Gujarati & Porter, 2021; White et al., 1989). Although GLS cannot eliminate all forms of endogeneity, it provides more efficient and unbiased parameter estimates compared to Ordinary Least Squares (OLS) under conditions of non-spherical error structures (Gujarati & Porter, 2021; White et al., 1989). The regression equation for testing the central hypothesis of this study can be described as follows:

$FPS_{i,t} = \alpha 0 + \beta ESGP_{i,t} + \delta \text{Firm Control}_{i,t}$ + Year Fixed Effect + Industry Fixed Effect + ε_{it} ....(2)

4. Results And Discussion

4.1. Descriptive Statistics

Table 1 presents the descriptive statistics for the variables used in the regression model of this study. The ESG score variable represents the cumulative ESG score of the sample companies, with an average cumulative ESG score of 45.02, a standard deviation of 19.70, and a maximum value of 89.64. This indicates that the average ESG score within the study sample is moderate. This study disaggregates explicitly the cumulative ESG score into its respective dimensions. The ENV variable represents the environmental performance of the company, with an average environmental performance score of 35.14 and a standard deviation of 24.75 in the sample. The GOV variable represents corporate governance performance, with an average governance performance score of 46.65 and a standard deviation of 22.42 in the sample. The SOC variable represents the social performance of the company, with an average social performance score of 50.03 and a standard deviation of 22.63 in the sample.

The Z-Score represents the company's financial performance, measured using the Altman Z-Score approach. The average financial performance score of the sample companies is 11.90, with a standard deviation of 4.90, suggesting that the sample companies, on average, are in a financially sound condition. The lowest financial performance score in the sample is -0.38, with a maximum score of 26.39, indicating a diverse range of financial conditions across the sample companies. The DMsh variable represents the decline in the company's financial performance. Of the total observations, 52% of the data indicate a decline in financial performance during the study's observation period. The study also incorporates control variables, including size (Size), Liquidity (Liquidity), sales ratio (SalesRatio), fixed asset ratio (PPERatio), and intangible asset ratio (Intangible).

Table 1.
Descriptive Statistic

Variables	Obs	Mean	Std.dev	Min	Max
ESGScore	450	45.02	19.70	7.44	89.64
ENV	450	35.14	24.75	0.00	91.64
GOV	450	46.65	22.42	2.98	94.01
SOC	450	50.03	22.63	4.55	96.95
DMsh	450	0.52	0.50	0.00	1.00
Size	450	14.75	1.00	10.12	17.08
Liquidity	450	2.13	1.60	0.10	10.64
SalesRatio	450	0.74	0.54	0.00	3.15
PPERatio	450	0.51	0.42	0.00	2.14
Intangible	450	0.07	0.14	0.00	0.82
Z-Score	450	11.90	4.90	-0.38	26.39

Source: Processed data, 2025

4.2. Hypothesis Statistics

This study uses the Generalized Least Squares Testing Model in hypothetical testing to mitigate the risk of heterogeneity problems in the data used. In the process of testing the hypothesis, this study performs winsorization of the research data at the 1% level above and below the mean. The results in Table 2 indicate that the value of the Financial Shortfall coefficient (- 4.60) is statistically significant at the 0.05 error margin. According to the statistical hypothesis test, this study concludes that the hypothesis is not supported. Furthermore, this study also presents companies' ESG performance based on three main pillars of sustainable performance separately (environmental, social, and governance) to identify performance patterns of Indonesian companies when faced with short-term financial declines. The test results show negative and statistically significant coefficient values for governance pillar (-5.41) and social pillar (7.14).

Table 2.
Hypothesis Statistic

Variable	Dependent: ESG Score	Dependent: ENV	Dependent: GOV	Dependent: SOC
Shortfall	-4.60**	0.27	-5.41**	-7.14**
Size	3.64**	6.21***	2.68**	3.18**
Liquidity	-0.39	0.00	0.52	-1.14
SalesRatio	4.57**	12.73***	1.96	1.42
PPERatio	7.35**	3.57	5.52**	7.71**
Intangible	11.25	-3.97	6.40	17.62**
Constanta	-13.33	-67.63	4.10	3.02
*, **, *** indicates signification level on 10%, 5% and 1%.				

Source: Author's processed data, 2025

4.3. Additional Analysis

This study employs the Generalized Least Squares Testing Model in hypothetical testing to mitigate the risk of heterogeneity issues in the data used. In the process of testing the hypothesis, this study performs winsorization of the research data at the 1% level above and below the mean. The results in Table 2 indicate that the value of the Financial Shortfall coefficient (- 4.60) is statistically significant at the 0.05 error margin. Specifically, this study presents the company's ESG performance in terms of three key pillars of sustainable performance separately (environmental, social, and governance pillars), to identify the performance patterns of companies in Indonesia when faced with the decline in short-term financial performance. The test results showed negative and statistically significant coefficient values for governance pillars (-5.41) and social pillars (7.14)

Table 3.
Additional Analysis

Variable	Dependent: ESG Score	Dependent: ENV	Dependent: GOV	Dependent: SOC
ZScore	-1.99***	-2.68***	-1.25**	-2.39***
Size	3.43***	6.16***	2.49**	2.82**
Liquidity	3.74***	4.62***	3.86**	3.73**
SalesRatio	21.58***	32.80***	13.71**	22.54***
PPERatio	9.20***	5.77**	7.11**	9.83***
Intangible	9.56	-6.08	5.62	15.10
Constanta	-10.58	-59.85	3.03	6.83

*, **, *** indicates signification level on 10%, 5% and 1%.
Source: Author's processed data, 2025

4.4. Discussion

The possible explanation for the inconsistency of the results with the hypothesis of this study is that corporate stakeholders in developing countries, such as Indonesia, still do not have confidence and trust in the environmental, social, and corporate governance strategies and activities, which affect the less effective ESG performance as a signaling mechanism for samples of companies in Indonesia (DasGupta, 2022; Huang, 2022; Naeem et al., 2022). Meanwhile, the possible explanation of the pattern is that environmental, social, and governance (ESG) activities of companies in developing countries, such as Indonesia, are carried out to meet corporate legal and social contractual obligations that are not related to corporate assessment (Kurniawan et al., 2024; Naeem et al., 2022), so that activities that support corporate compliance with legal obligations and social contract will decrease as the company's financial performance declines.

The findings in this study are more focused on the shareholder perspective. Specifically, shareholder theory emphasizes the company's goal of providing benefits to shareholders (Peng & Isa, 2020; Putri et al., 2024; Sumiyana, S., Na’im, A., Kurniawan, F., & Nugroho, A. H. L., 2023). Indications of a focus on shareholders arise because companies tend to reduce their emphasis on ESG implementation when they experience a decline in performance. The decline in ESG implementation leads to the company's focus shifting more towards shareholders, considering that ESG implementation is viewed as an obligation that is not higher than the interests of shareholders (Huang, 2021; Kurniawan et al., 2024; Putri et al., 2024). Furthermore, companies tend to prioritize diverting resources from these ESG activities to restore short-term financial performance and generate shareholder interests (Huang, 2022; Peng & Isa, 2020). In addition, companies still consider ESG priorities to be a minor strategy for improving reputation and sustainability, due to the value or implementation of ESG.

Additional analysis confirms the findings of this study, which indicate that environmental, social, and governance (ESG) performance in Indonesia has not been used as a signaling mechanism to create bias in the assessment of corporate financial performance (Huang, 2022; Lys et al., 2015; Paulraj, 2011). The negative relationship between financial performance conditions and ESG performance is likely to occur because stakeholders and investors in developing countries such as Indonesia have a low level of confidence in the environmental, social, and corporate governance strategies (Naeem et al., 2022; Sumiyana, Na’im, et al., 2023; Sumiyana, Naق│└im, et al., 2023). Thus, the relationship pattern between the financial performance of companies in Indonesia is more likely to be explained by using the Institutional Theory and the Stakeholder Theory compared to the signaling theories, because of the lack of confidence of stakeholders and investors in developing countries, not using environmental, social, and governance activities as a signaling mechanism, and preferring to allocate resources to areas that provide increased competitive adventures to restore the financial condition of companies (Paulraj, 2011).

CONCLUSION

Stakeholders and investors in developing countries have low levels of trust in environmental, social and corporate governance strategies (Naeem et al., 2022). Thus, the pattern of relationship between the financial performance and ESG performance of companies in developing countries, including Indonesia, is more likely to be explained by using institutional theory and/or stakeholder theory (Freeman, 2010) compared to signaling theory. The results of this study indicate that a decrease in short-term financial performance for the Indonesian research sample tends to be associated with reduced corporate ESG performance. This suggests that companies in Indonesia do not utilize their ESG performance as a signaling mechanism to obscure the assessment of their financial performance. The results of this study are also reinforced by additional analysis that show patterns of decreased ESG performance, along with improved financial conditions of the company. This indicates that environmental activities, social responsibility, and corporate governance have not been a priority allocation of corporate resources.

This study provides policy implications that can support the development of ESG practices in Indonesia. Supervisory authorities, such as the Financial Services Authority (OJK), are expected to improve their ESG disclosure frameworks and strengthen their enforcement mechanisms. Improving the clarity and reliability of these frameworks can increase stakeholder confidence in the credibility of ESG-related information. Policymakers should consider implementing specific incentives or establishing more transparent and enforceable standards for ESG activities, particularly for companies facing financial distress. This is crucial to ensure sustainability commitments are maintained even under challenging financial conditions. Corporate actors are advised to adopt a proactive ESG communication strategy. By effectively communicating their ESG efforts, particularly during periods of financial downturns, companies can mitigate negative perceptions from stakeholders and maintain legitimacy among investors and the public. This integrated effort has the potential to foster a more transparent, resilient, and sustainable corporate landscape in Indonesia.

The results of this study are expected to help investors and analysts better understand the intent behind environmental, social, and governance ESG performance. This study provides evidence that corporate ESG performance in Indonesia is not a form of signaling mechanism used by companies to obscure their actual performance.

This study only uses ESG performance, which is limited to specific companies in Indonesia. This research is limited to calculating short-term performance declines cross-sectionally by industry sector without considering the company's historical aspirations. Furthermore, this study's limited sample size in Indonesia reduces the generalizability of the findings to developing countries.

Future research is expected to consider the quality of corporate environmental, social, and governance disclosures as part of the dependent variable to capture a broader range of signaling mechanisms. Furthermore, future research could consider historical aspirations as part of measuring short-term financial performance declines to broaden the benchmark for corporate financial performance declines.

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