

# The Role of ESG and Financial Performance in Enhancing Corporate Financial Flexibility in Indonesia

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## ABSTRACT

This research was conducted to examine the influence of Environmental, Social, and Governance (ESG) performance and financial performance on financial flexibility. The object of the research is a company listed on the Indonesia Stock Exchange from 2022 to 2024 and has an ESG performance every year on the Thomson Reuters database. The research method used is quantitative with a correlational descriptive design. The analysis technique uses multiple linear regression. The results show that financial performance and ESG performance have a significant positive effect on financial flexibility. This indicates that ESG performance and financial performance can increase a company's financial flexibility. Therefore, to maintain and increase financial flexibility, companies need to pay attention to aspects of company performance, both non-financial performance in this case ESG and financial performance. This study is limited to companies that report ESG performance to Thomson Reuters, so for future research it can use other ESG performance indices such as the Bloomberg database and the Dow Jones sustainability index.

**Keywords:** Environmental, Social, and Governance; Financial Flexibility; Financial Performance.

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## INTRODUCTION

Financial flexibility receives significant attention as an important determinant of a company's ability to deal with uncertain conditions. In addition, financial flexibility can be used to measure a company's investment opportunities and its ability to maintain a long-term competitive advantage. This allows companies to manage their assets, capital, and liabilities to optimize operational efficiencies to maintain sustainable growth [1]. Without good financial flexibility, the future of the company will face great obstacles.

Some of the problems of financial flexibility occur in companies in Indonesia, including PT Krakatau Steel Tbk (KRAS). Based on KRAS's financial statements for 2015-2021, there has been negative cash flow pressure caused by overinvestment in long-term projects without good financing planning. This has led to debt restructuring of more than 30 trillion and as a result the company has made massive efficiency. The same problem is also faced by PT Garuda Indonesia Tbk (GIAA). GIAA is unable to meet its short-term and long-term obligations. This is due to weak control of operational expenses. Another thing that causes problems in GIAA is the high level of leverage and the absence of liquidity reserves. This problem caused

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GIAA's shares on the IDX to be suspended and the company underwent a massive restructuring.

At the same time, sustainability issues also continue to be a global concern, pressuring companies to focus not only on financial targets but also on non-financial performance, namely *Environmental, Social, dan Governance* (ESG). IFRS Foundation demonstrate its support for ESG performance by forming a International Sustainability Standards Board (ISSB) in 2022 as a standard-setting institution that specializes in developing sustainable performance reporting standards. Now the company is not only judged by its financial performance, but also by its commitment to non-financial performance, namely environmental sustainability, ethical social practices, and a strong governance structure [2]. ESG performance encompasses a wide range of metrics, including environmental impact, employment relations, product responsibility, corporate governance, and community engagement [3]. Therefore, ESG performance considerations into investment decisions are increasingly crucial because they have the potential to obtain increased long-term financial returns. ESG performance can reduce *financing constraints*, Lower the cost of capital so as to increase financial flexibility [4].

In an increasingly dynamic and competitive business environment, a company's ability to survive and thrive is largely determined by healthy and adaptive financial conditions. One of the fundamental factors that is believed to play an important role in shaping financial flexibility is the financial performance of the company itself. Good financial performance is usually reflected in high liquidity, stable profitability, operational efficiency, and a healthy capital structure. Companies with good financial performance generally have more access to funding sources, both internally and externally, which can increase their financial flexibility. Research [5] It shows that financial performance measured by profitability and liquidity directly affects a company's financial flexibility, particularly in the context of developing countries facing limited access to external capital. In contrast, companies with poor financial performance may face limitations in obtaining financing or have to bear higher capital costs, which ultimately narrows its room for maneuver in making strategic financial decisions. Thus, there is a strong indication that there is a relationship between the company's financial performance and the level of financial flexibility it has.

Financial flexibility is the ability of a company to efficiently adjust and access its financial resources in the face of changing business environments, risks, or strategic opportunities. This flexibility includes aspects of liquidity, leverage, capital structure, and adaptability to external pressures. ESG performance is increasingly considered an important indicator in assessing the quality of management and company sustainability. Recent research shows that companies with high ESG performance tend to have better financial flexibility. This flexibility is reflected in the company's ability to access funding, manage risk, and maintain operations during periods of economic uncertainty. Companies with good ESG practices have a more positive reputation in the eyes of investors and financial institutions. This lowers credit risk and increases access to funding, both through capital markets and bank loans [12], [13]. ESG often drives companies to innovate green and energy efficiency, which in the long run reduces costs and improves

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financial flexibility [14,15]. From several previous studies, it can be concluded that ESG performance can increase a company's financial flexibility. So the first hypothesis in this study is as follows.

H1: ESG performance can improve a company's financial flexibility

Financial performance refers to a company's ability to generate profits, manage costs, maintain profitability, and create value for shareholders. Meanwhile, financial flexibility is the ability of a company to respond to changes in the financial environment, such as a recession, investment opportunities, or liquidity crisis, without disrupting operations. This includes the ability to access funds, delay or accelerate capital expenditures, and maintain healthy leverage. Companies with good financial performance generally have more access to funding sources, both internally and externally, which can increase their financial flexibility. Research shows that financial performance measured by profitability and liquidity directly affects a company's financial flexibility, particularly in the context of developing countries facing limited access to external capital [5]. Profitability and stable cash flow significantly improve investor sentiment, strengthening investor confidence in management and business continuity and increasing the company's financial flexibility [16]. From some of the results of the study, it can be concluded that financial performance can increase financial flexibility, so the second hypothesis in this study is.

H2: Financial performance can improve the financial flexibility of a company

Based on the development of the hypothesis, the framework of thought in this study is.

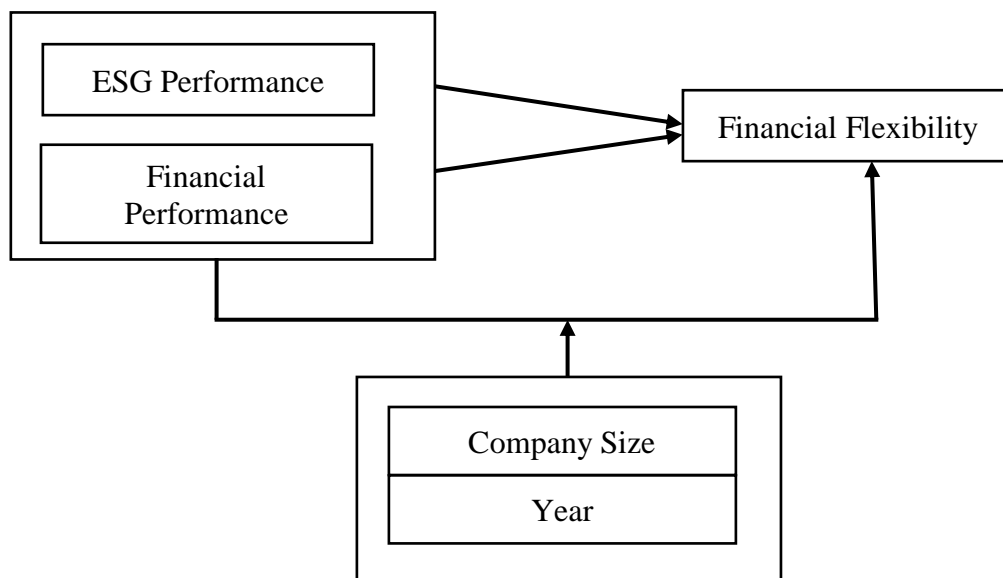


Figure 1. Framework of thinking

**METHOD**

This study uses a quantitative approach with a correlational descriptive design to determine the relationship between independent variables, namely ESG performance, and financial performance to dependent variables, namely financial flexibility. The population in this study is all companies listed on the Indonesia

Stock Exchange in 2022 – 2024. Sampling was carried out by purposive sampling technique. Some of the criteria used as a reference are companies listed on the Indonesia stock exchange in 2022-2024, have ESG performance every year at Thomson Reuters and report financial statements every year. From these criteria, 44 companies were obtained as the object of the research. So that 132 observations data were collected for data processing. In this study, the authors included a year as a control variable to differentiate between the periods during and after the pandemic. This is in line with statements from the World Health Organization (WHO) and the government that the pandemic will not be declared over until mid-2023.

The data analysis technique used is inferential statistics. Inferential statistics are statistics used to predict or test hypotheses in a certain part of the population. This study used a linear regression test with the help of Stata software version 18. The operationalization of the variables in this study are.

**Table 2. Variable Operationalization**

Variable Name	Definition	Source	
Financial flexibility	Cash and cash equivalents are deflated with the total assets in the company in the year to t.	Indonesia Exchange	Stock
ESG <sub>it</sub> performance	Combined ESG score in companies in year i-1	Thomson Reuters	
Financial performance	Net profit deflationary with total assets	Indonesia Exchange	Stock
Variable Control			
Year <sub>it</sub>	Differentiate the period before and during the pandemic using <i>dummy</i> variables: Period during pandemic = 0 Post-pandemic period = 1	Attached by the researcher	
Size <sub>it</sub>	The natural logarithm of the total assets in the company i year t.	Indonesia Exchange	Stock

The research model is as follows.

$$FF_{it} = \beta_0 + \beta_1 ESG_{it-1} + \beta_2 FP_{it} + \beta_3 Year_{it} + \beta_4 Size_{it} + \epsilon_{it}$$

Description:

FF<sub>it</sub> : Deflated Cash and cash equivalents with total assets in company i year t

ESG<sub>it-1</sub> : ESG Performance in company i year t-1

FP<sub>it</sub> : Financial Performance in company i year t

Year<sub>it</sub> : Dummy year

Size<sub>it</sub> : Firm size (logarithm of natural assets)

## RESULTS AND DISCUSSION

### Statistics descriptive

Descriptive statistics provide a concise overview of the main characteristics of the analyzed data such as mean, median, mode, standard deviation, and minimums and maximums used to understand the distribution and consistency of the data. The following is a table of the results of descriptive statistical analysis.

**Table 3. Statistics Descriptive**

Deskriptio	N	Min	Max	Mean	Std. Dev
Financial Flexibility	132	0,00413	0,54175	0,10845	0,09350
ESG <sub>t-1</sub>	132	16,93000	87,75000	56,47333	18,48047
Financial Performance	132	-0,05072	0,45427	0,07674	0,08223
Year	132	0,00000	1,00000	0,66667	0,47320
Dummy Size	132	12,52522	22,37903	17,68508	2,16668

Based on table 3. it is known that financial flexibility has the lowest value of 0.00413, while the highest value is 0.54175. Furthermore, the ESG<sub>t-1</sub> has the lowest value of 16.93000 or is in the poor category. This indicates that there are companies that do not pay attention to ESG or are involved in matters that result in major controversies. While the highest value of the ESG<sub>t-1</sub> is 87.75000 or is in the excellent category, it means that the company has excellent and transparent ESG practices. Financial performance as measured by profitability has the lowest value of -0.05072 which means the company suffers losses, while the highest value of financial performance is 0.45427 which means that the company can generate a profit of IDR 45 for every IDR 1 asset.

### Classic Assumption Test

Before conducting regression analysis, a classical assumption test is first carried out to ensure that the model used meets the requirements of good and unbiased OLS estimation. Based on the results of the test using Stata software, the overall results of the classical assumption test, it can be concluded that the linear regression model used has fulfilled all classical assumptions, so it is suitable for use in the analysis stage and drawing further conclusions.

### Discussion

The results of data processing in this study are shown in the following table

**Table 4. Regression Output**

y	Robust			
	Coefficient	std. err.	t	P> t
x1_resid	1	.0039441	253.54	0.000
x2	.2624319	.0020713	126.70	0.000
FS	-.0522159	.0007282	-71.70	0.000
Dummy	-.0050156	.0003022	-16.60	0.000
_cons	1.0151	.0130497	77.79	0.000

### **The Effect of ESG Performance on the Company's Financial Flexibility**

Based on table 4. It is known that the P value of the  $< \alpha$  set is 0.05. So that the first hypothesis in this study was accepted. It can be concluded that ESG performance has a significant positive effect on financial flexibility. Companies that have good performance in the Environmental, Social, and Governance aspects tend to have more flexible or adaptive financial capabilities in dealing with financial pressures and investment opportunities. This is because the company is considered to be able to reduce exposure to risks that can harm the company. In addition, companies are also considered to be able to choose cheaper access to financing so as to reduce the company's dependence on debt. This can increase investor confidence to invest because the company is considered to be able to provide long-term stability. The company will have a higher capacity to manage its financial structure, be able to maintain liquidity, and be able to access funding sources more efficiently amid uncertain market dynamics. This is in line with the results of research conducted by [10] that states that ESG performance has an effect on positive for the company's flexibility and financial performance. Companies with high ESG scores have better ability to face challenges and adjust financial strategies quickly. Financial flexibility is significantly influenced by ESG, and companies with high ESG tend to be more sustainable because they have flexible financial structures [17].

### **The Effect of Financial Performance on the Company's Financial Flexibility**

Based on table 4. It is known that the P value  $< \alpha$  is 0.05. So that the second hypothesis in this study is accepted. Therefore, it can be concluded that financial performance has a significant positive effect on financial flexibility. This means that financial performance can increase financial flexibility. The higher the financial performance, the better the financial flexibility, so that the company has a higher ability to manage the assets owned by the company. Companies that have high profitability are able to build the company's internal funds from the profits earned every year. This can reduce the company's dependence on expensive external financing. So it can be ensured that the company is able to fund investment activities from internal funds. High financial performance allows companies to have high cash reserves that can be used as a buffer for the company when facing a recession or taking advantage of new opportunities such as research and development activities. Companies that have high financial performance also allow obtaining funding more easily because they are considered to have a low risk of default. This also increases investor confidence to invest so that companies have easy access to financing.

This is in line with research conducted by [18] shows that companies with good financial performance have greater financing flexibility and are able to be more adaptive to global economic dynamics. Study [19] demonstrate that flexible financial instruments support financial performance outcomes and create a mutually reinforcing relationship between financial performance and flexibility.

## **CONCLUSION**

There are several things that can be concluded from this study. ESG performance has a positive effect on financial flexibility, meaning that companies

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with high ESG scores have a better ability to manage financial structures, maintain liquidity, and access funding sources efficiently in the face of market dynamics. Financial performance proxied by ROA has a positive effect on financial flexibility. The higher the financial performance, the greater the financial flexibility, so that the company has a higher ability to manage the assets owned by the company.

This study is limited to the ESG performance provided by Thomson Reuters database, so the number of companies used as research samples is limited. So the suggestion for further research is to be able to use other *databases* to obtain ESG performance values such as *Bloomberg database* and *the Dow Jones sustainability index* so that the number of companies used as research samples is more.

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