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Model Sustainability and Financial Performance of SME in Bali

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Abstract—This research aims to build a model of sustainability practices in improving the financial performance of SMEs in Bali by analyzing the role of sustainability performance as a mediator and the role of environmental policy as a moderator of green innovation towards sustainable practices of SMEs in Bali. This study uses a quantitative method with a survey design. The survey was conducted on 390 SMEs in Bali. The questionnaire was distributed directly to SME managers using stratified random sampling. Hypothesis testing was carried out using the SEM-PLS approach with the help of SmatPLS.3.0 software. The results of the study indicate that the variables of green innovation, sustainability performance and environmental policy directly affect the financial performance. These findings fully support stakeholder theory, RBV theory and legitimacy theory. This study also found the role of sustainability performance in mediating the relationship between green innovation and financial performance. In addition, it was also found that environmental policy plays a role in moderating the relationship between green innovation and sustainability performance with financial performance. The results of this study reaffirm that sustainability performance can improve financial performance when companies involve the adoption of green technologies and practices.

Keywords: Green innovation; environmental policy; sustainability performance; financial performance; small and medium industries

Introduction

Small and Medium Industries (SMEs) play an important role in sustainable development and the national economy, with a population reaching 4.19 million business units, contributing 99.7% of the total industrial business units, absorbing 65.52% of the workforce, and contributing 21.44% of industrial output in 2023.(Yunita; Reni, 2024). However, the high consumption of natural resources by SMEs is feared to accelerate the resource crisis. Therefore, SMEs must be wiser in utilizing natural resources. (Tussadiah et al., 2021). Accenture 2022 survey shows that 65% of business actors in ASEAN, including Indonesia, are aware of the importance of sustainability, with a focus on new business models, resource efficiency, and sustainable products (Gonzalez, 2022)

Sustainability in business is the integration of practices and strategies that enable companies to operate in an environmentally, socially and economically responsible manner. (Kusumawati; et al., 2023) and attention to long-term business success and profitability. This integration includes the ability and commitment to balance business needs with the needs of society and the environment, taking into account the impact of business practices on society and the environment. (Wasiq et al., 2023). This means that economic performance is no longer the sole objective of the business world. Business actors are required to address social problems in society and preserve the natural environment. (Bombiak & Marciniuk-Kluska, 2018; Butt et al., 2022).

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The risky business operations of SMEs that threaten environmental stability encourage the importance of green innovation (Asadi et al., 2020; L. Li et al., 2022; M. Li et al., 2022). This innovation plays a strategic role in balancing sustainability and financial performance through the use of green materials, recycling, reducing production costs, and minimizing waste (Awan & Arnold, 2020). Process innovation can also reduce energy consumption and recycle waste into products with economic value (S. Liu et al., 2021; Marco-Lajara et al., 2022). Empirical evidence shows mixed results: some studies find that green innovation improves sustainability and financial performance (Rustiarini et al., 2022; Wasiq et al., 2023; Novitasari & Tarigan, 2022; Przychodzen et al., 2020), and social responsibility supports a company's financial performance (Bahta et al., 2020; Novitasari & Tarigan, 2022). However, other findings show that these innovations do not always improve sustainability performance and can have a negative impact on firm value (Monogina & Rachmawati, 2023; Pangesti, 2023). There is also a negative relationship between sustainability practices, especially in the environmental and social dimensions, and improved financial performance (Fauzi & Mahoney, 2007; Puteri et al., 2018; Weston & Nnadi, 2023).

The inconsistent research results encourage further research, because the relationship between green innovation, sustainability, and financial performance is still controversial. Contingency factors, such as government support through environmental policies, are thought to influence these results. (Hayatulah et al., 2023; L. Liu et al., 2023) emphasized that environmental policies encourage green energy efficiency, and can act as moderating variables that strengthen the relationship between green innovation, sustainability practices, and improved corporate financial performance. This research is important to conduct because: First, the majority of businesses in ASEAN, especially Indonesia, are SMEs that are significant in the economy, but face sustainability issues (Gonzalez, 2022; Yunita & Reni, 2024). Second, previous studies have focused more on large companies, while research on sustainability in SMEs is still limited (Poerwanto & Pranatasari, 2019), even though SMEs collectively have the potential to have a greater negative environmental impact. SMEs need to improve their social and environmental performance to achieve long-term economic benefits (Neri et al., 2018). Third, there is a literature gap on how SMEs, especially in the regions, address sustainability issues, and there is no clear path for local businesses to integrate sustainability into their business strategies (Artin, 2022). Green innovation is seen as a win-win solution to the conflict between economic development and environmental protection (Marco-Lajara, Zaragoza-Sáez, et al., 2022).

Organizations play a vital role in society and economy, where financial performance does not occur in isolation, but rather through responses to various risks related to the concept of sustainability. This study aims to build a model of sustainability practices that drive the financial performance of SMEs in Bali with a mediation-moderation approach, involving green innovation strategies and government environmental policies as moderating variables. This study differs from previous studies because it develops environmental policies as a contingency factor, offering a new approach that has never been done to understand the relationship between green innovation, sustainability performance, and financial performance in SMEs in Bali.

Concept and Hypothesis

Stakeholder Theory

Stakeholder Theory, proposed by R. Edward Freeman in 1984 through his book Strategic Management: A Stakeholder Approach, emphasizes that companies must pay attention to various stakeholders, not just shareholders, for long-term sustainability. Stakeholders such as customers, employees, communities, and regulators play an important role in influencing a company's strategy and performance. This theory is relevant in the context of green innovation, where companies that meet stakeholder expectations regarding sustainability can avoid risks and seize market opportunities. Sustainability performance,

which includes environmental, social, and governance (ESG) aspects, also contributes to improved financial performance by attracting investors and strengthening reputation (Eccles et al., 2014). Strict environmental policies encourage green innovation, which in turn strengthens the relationship between sustainability performance and a company's financial performance (Porter & Van der Linde, 1995).

RBV Theory

This study uses the Resource Based View (RBV) Theory. Based on the RBV theory (Barney, 1991), that the capabilities and resources of an organization are the main determinants of competitive advantage. The capabilities of a company depend on the environmental conditions in which the company operates (Xie et al., 2019). Faced with external and internal pressures to implement and adapt green organizational practices, it is increasingly important for businesses to cultivate green organizational capabilities. From the RBV perspective, environmental policies and green innovation strategies are valuable intangible resources for firms. (Asadi et al., 2020). In the long term, green innovation enables organizations to develop and improve organizational, environmental and social sustainability as well as the company's competitive advantage (Novitasari & Tarigan, 2022).

Legitimacy Theory

Legitimacy Theory, first introduced by John Dowling and Jeffrey Pfeffer in 1975, states that companies must operate in accordance with the values and expectations of society to gain social legitimacy. In the context of environmental policy, companies that comply with or exceed environmental regulations can increase positive perceptions from the community and stakeholders, which results in improved reputation, consumer loyalty, government support, and investment. This ultimately contributes to improved financial performance of the company. This theory provides an understanding that compliance with environmental policies can strengthen social legitimacy, which in turn attracts more customers and investors, and reduces reputational and legal compliance risks, thus creating a positive relationship between environmental policies and financial performance (Deegan, 2002).

Financial performance

Financial performance refers to the evaluation of an organization or company's ability to manage financial resources to achieve set goals. Good financial performance indicates that the company is able to generate profits, manage financial risks, and provide value to stakeholders. It is also important for strategic decision making, such as investment, product development, and market expansion. In addition, understanding financial performance also helps in planning for the future and maintaining business continuity. The financial performance of SMEs (Small and Medium Enterprises) refers to the ability of a business to generate profits, manage costs, and create added value from its resources. Some financial performance indicators commonly used to assess SMEs include: 1) Profitability, which measures the company's ability to generate profits from sales, often measured through gross profit margin, net profit margin, and return on equity (ROE), 2) Liquidity, which is the ability of SMEs to meet short-term obligations, measured by the current ratio and quick ratio, 3) Solvency, which measures the company's ability to meet long-term obligations, often assessed through the debt to equity ratio, 4) Revenue Growth, which is the rate of increase in revenue from year to year, which reflects the potential for market expansion and success, 5) Operational Efficiency, which measures how well the company uses assets and resources to generate revenue, which can be assessed through the asset turnover ratio (Acs and Szerb, 2023, Hassan, & Ali, 2022, Cohen, & Schmid., 2023).

Sustainability Performance

Sustainability performance refers to an organization's ability to operate in a manner that takes into account the social, environmental, and economic impacts of its activities. It

encompasses a holistic approach that focuses not only on financial returns, but also on achieving broader social and environmental goals. In the context of SMEs (Small and Medium Enterprises), sustainability performance encompasses how SMEs manage the social, environmental, and economic impacts of their operations. The challenges faced by SMEs in managing sustainability performance include 1) Limited Resources, that many SMEs do not have a large budget for sustainability initiatives compared to large companies, 2) Lack of Knowledge and Skills, that SME owners often do not have sufficient knowledge about effective sustainability practices, and 3) Price Competition, that SMEs may feel pressured to offer lower prices, thus neglecting more expensive sustainability practices (Rudolph, & Dyer, 2023; Kumar & Sharma, 2022, Mazzarol & Reboud, 2023). Understanding sustainability performance is key to developing business strategies that are not only financially profitable but also support sustainable development.

Green Innovation

Green Innovation refers to the development of products, services, or processes designed to reduce negative impacts on the environment. The goal is to create more sustainable and efficient solutions, and encourage wiser use of resources (Carnillo et.al, 2022). The implementation of green innovation in SMEs not only helps reduce negative impacts on the environment, but can also improve the competitiveness and reputation of the business (Khan & Quaddus, 2023). With the right steps, SMEs can contribute significantly to sustainability goals. green innovation is becoming increasingly important in the context of climate change and environmental degradation. By focusing on developing more sustainable solutions, companies can not only meet the demands of increasingly environmentally conscious consumers but also contribute to global sustainability goals.

Environmental Policy

Environmental policy in the context of SMEs (Small and Medium Enterprises) refers to the strategic steps taken by companies to manage the impact of their operations on the environment. This policy includes not only compliance with applicable environmental regulations, but also efforts to integrate sustainability into daily business practices (Kumar & Prakash. 2022). Furthermore, Horbach & Rennings, 2022), stated that aspects of environmental policy in the context of SMEs include 1) SMEs must comply with environmental regulations set by the government, such as environmental permits, waste management, and emission limits. These are basic steps that must be taken to avoid legal sanctions, 2) Environmental policies include strategies for using resources efficiently, such as reducing energy and water consumption, and using sustainable raw materials, 3) SMEs develop programs that focus on sustainability, such as recycling, using renewable energy, and reducing waste. This policy can also include education and training for employees to raise awareness of green practices, 4) SMEs set metrics to measure the effectiveness of the environmental policies implemented. SMEs need to conduct regular evaluations to assess progress and make necessary adjustments, and 5) SMEs can create sustainability reports that demonstrate their commitment to environmental policies. This can include information about achievements, challenges, and plans for the future.

The Impact of Green Innovation on Financial Performance

From the Resource-Based View (RBV) perspective, innovation is viewed as a unique and valuable resource that can provide sustainable competitive advantage and positively affect a company's financial performance. RBV emphasizes the importance of valuable, rare, difficult to imitate, and non-substitutable internal resources to create a sustainable competitive advantage. Research shows that companies that implement green innovation, such as green product development, energy-efficient production processes, and sustainable environmental management, tend to experience increased profitability through reduced operating costs and improved corporate image. For example, a study in China found that green technology innovation improves financial performance by improving energy efficiency and reducing

negative environmental impacts, as well as helping companies save costs and take advantage of government incentives (Khan et al., 2023; Ha et al., 2023). Furthermore, research in Southeast Asian countries shows that companies with green innovation strategies are often more competitive, which in turn improves financial performance through improved reputation and consumer loyalty (Lawrence et al., 2024). Overall, the positive relationship between green innovation and financial performance is increasingly evident, especially for companies that are able to integrate environmental innovation into their business strategies.

H.1 Green innovation has a positive impact on a company's financial performance.

The Impact of Green Innovation on Sustainability Performance

Legitimacy theory states that organizations seek to align their operations with social norms and expectations to maintain a social license to operate. Green innovation, such as the adoption of sustainable processes and products, helps companies demonstrate their commitment to sustainability, increases trust and support from stakeholders, and contributes to better sustainability outcomes. Green innovation practices not only satisfy regulations but also enhance a company's reputation and create long-term competitive advantages. Several studies have shown that green innovation, supported by subsidies and regulations, significantly improves environmental and financial performance, especially in highly polluting industries. For example, research in China revealed that companies that adopted green innovation under stakeholder pressure often improved their performance and gained legitimacy from these groups (Cheng et al., 2024; Xie et al., 2024; Liu et al., 2024). Substantial evidence supports that companies that engage in green innovation, such as emission reduction and adoption of green technologies, enhance their reputation and achieve better sustainability performance, especially in regions with strict environmental regulations. Research by Shiu et al. (2024) also showed that strategic green innovation significantly improves environmental performance. These findings underscore the importance of legitimacy in guiding the contribution of green innovation to sustainable business practices. Thus, green innovation serves as a catalyst for sustainable performance, benefiting companies economically while fulfilling environmental and social responsibilities.

H2. Green innovation has a positive impact on sustainability performance.

The Impact of Sustainability Performance on Financial Performance

Stakeholder theory states that companies should consider the interests of various stakeholder groups, including employees, consumers, communities, and the environment, in addition to shareholder interests. Commitment to sustainability through green practices and social responsibility can strengthen relationships with stakeholders, which has a positive impact on financial performance. Ionone and Serafeim (2021) and Ameer and Othman (2022) show that companies that implement corporate social responsibility (CSR) practices tend to have better financial performance. A study by García-Sánchez and García-Meca (2021) in Spain revealed that engagement with stakeholders through sustainability initiatives can increase profitability and company value. These findings are supported by Albuquerque, Durnev, and Koskinen (2020) and López-Navarro and García-Castro (2023), who found that companies with good sustainability practices have lower risks and better financial performance. In addition, attention to stakeholders can increase customer loyalty and attract greater investment. This empirical evidence shows a positive relationship between sustainability performance and financial performance, supporting stakeholder theory that attention to the interests of various parties can create sustainable value for the company.

H3. Sustainability performance has a positive impact on financial performance

The Impact of Environmental Policy on Financial Performance

Legitimacy theory emphasizes the importance of support from various stakeholders for the survival and development of a company. Good environmental policies can increase a

company's social legitimacy by encouraging the adoption of more efficient practices, such as waste reduction and the use of renewable energy, which can potentially reduce operating costs. Hart (2023) noted that companies that implement environmental policies managed to reduce energy costs by up to 20%. Companies with clear environmental commitments tend to gain more trust from customers, which contributes to increased sales; Smith and Zhang (2024) found that 75% of consumers are more likely to buy products from companies with good environmental policies. In addition, Johnson et al. (2023) showed that investors increasingly consider environmental factors in investment decisions, which increases the attractiveness of investment. Companies with environmental certification often get lower interest rates on loans. Strong environmental policies also help companies comply with existing regulations, reducing the risk of fines and sanctions. Lee and Kim (2024) found that companies that are proactive in environmental policies can reduce the legal risks associated with environmental violations. In addition, these policies encourage innovation in products and services, increasing the company's competitiveness in the market. Patel and Gupta (2023) found that companies that focused on green innovation experienced a 15% increase in market share compared to competitors.

H4. Environmental policies have a positive impact on financial performance.

The influence of sustainability performance in mediating the relationship between green innovation and financial performance

From the perspective of stakeholder theory, companies must consider the needs and interests of all parties involved. Green innovation emerges as a response to stakeholder demands, including more environmentally conscious consumers and government regulations. Sustainability performance reflects the fulfillment of stakeholder expectations and building positive relationships with them. By focusing on sustainability performance, companies can improve relationships with stakeholders, which in turn supports better growth and financial performance. Zhao and Wu (2019) found that sustainability performance significantly mediates the relationship between green innovation and corporate financial performance. This study used data from the manufacturing sector and showed that effective green innovation can improve sustainability performance, which has a positive impact on profitability. Similar findings were also revealed by Cai and Liu (2017), who found that companies that implement green innovation well tend to have higher sustainability performance, which leads to improved financial performance.

H5. Sustainability performance has a positive effect on the relationship between green innovation and financial performance.

The Influence of Environmental Policy in Moderating the Relationship between Green Innovation and Financial Performance

From the Resource-Based View (RBV) perspective, green innovation is recognized as a strategic resource that differentiates a company from its competitors. It includes new technologies, efficient processes, and sustainable products that can enhance a company's capability to meet market and stakeholder needs. Favorable environmental policies act as a driver for companies to develop and utilize green innovation. Chen (2008) showed that favorable environmental policies can enhance a company's ability to utilize green innovation, which in turn can contribute to improved financial performance. Empirical evidence from Hoffman and Jennings (2018), Zhang and Zhao (2020), and Raut and Jha (2021) indicates that stringent environmental policies can strengthen the relationship between green innovation and financial performance. Companies that are able to adapt to changing environmental policies tend to gain financial benefits from their innovations.

H6. Environmental policy strengthens the relationship between green innovation and financial performance.

The Influence of Environmental Policy in Moderating the Relationship between Sustainability Performance and Financial Performance

In the context of stakeholder theory, high sustainability performance reflects a company's concern for the interests of all parties involved, such as customers, communities, and governments. This can increase stakeholder trust and loyalty. Supportive environmental policies can influence stakeholder expectations; when companies improve sustainability performance in response to these policies, stakeholders will increasingly appreciate the company's efforts. Proactive environmental policies, as found by López-Navarro and García-Castro (2021), can strengthen the relationship between sustainability performance and financial performance. Companies that implement strict environmental policies often experience improved financial performance due to good sustainability practices. Findings from Wang and Sarkis (2017) and Zhang and Zhao (2019) also show that environmental policies act as a moderator in this relationship, increasing the effectiveness of sustainability performance in generating financial returns.

H7. Environmental policies strengthen the relationship between sustainability performance and financial performance.

Method

This study used a survey approach to collect data, which began with the preparation of a research instrument in the form of a questionnaire that included questions about green innovation, sustainability performance, financial performance, and environmental policy. Before the fieldwork, two SME practitioners were involved as resource persons to assess the strength of the questionnaire items. Content validity was tested through readability to ensure that statements were easily understood by respondents. After that, a trial was conducted to test the validity and reliability of the construct. The survey was conducted on 50 respondents, namely SME managers or owners in Denpasar City. The validity test used the Pearson product moment correlation method with the help of SPSS software version 25.0, which showed that all indicators were valid for measuring the variables studied, except for one indicator on sustainability performance which was removed from the model. The results of the reliability test showed the consistency of respondents' answers.

Here is the translation of the instrument measurement based on the validity and reliability tests through respondent traceability and pilot test results. 1) Green Innovation, refers to the company’s strategy in developing or implementing products, processes, or technologies aimed at reducing negative environmental impacts. This variable is measured using 6 statement items that reflect aspects such as energy efficiency, the use of environmentally friendly raw materials, and the implementation of technologies or production processes that reduce waste and emissions. 2) Sustainability Performance, sustainability performance focuses on the company’s achievements in three main aspects: economic, environmental, and social. This variable is measured using 10 statement items that cover indicators such as emission management, energy efficiency, employee welfare, and contributions to the surrounding community or environment. 3) Environmental Policy, refers to the rules, regulations, and guidelines adopted by the company to minimize the negative impacts of its operations on the environment. This is measured by 9 statement items that evaluate various aspects, such as waste management policies, the use of renewable energy, and compliance with environmental regulations. Financial Performance, refers to the economic outcomes achieved by the company, such as profitability, operational efficiency, and revenue growth. This variable is measured using 15 statement items, which may include metrics like profit margins, return on assets (ROA), return on equity (ROE), and other financial performance indicators.

Data collection was carried out using the stratified random sampling method throughout Bali, using the Slovin formula with a tolerance threshold of 5% of the total population of 14,869 SMEs, resulting in a minimum sample of 390 respondents. The

questionnaire was distributed directly by surveyors consisting of lecturers and students, with a total of 390 respondents responding, so the response rate was 100%. This process involved direct visits to the IKM location, accompanied by the provision of souvenirs as an award and reminder for staff to immediately fill out and return the questionnaire. The results of descriptive statistics show that respondents are over 50 years old, around 30.8%, the majority of respondents are male, around 59.2%, the most recent level of education is up to high school, and respondents with a business period of less than 10 years dominate the results of this study, around 55.10 years. The proposed hypothesis was analyzed using partial least squares (PLS). This technique is in accordance with the character of research that is oriented towards prediction (Hair, Risher, Sarstedt, & Ringle, 2019). The validity and reliability of the variables were tested in the first step in the analysis, followed by the analysis of the structural model.

Result and Discussion

Assessment of measurement models

To assess the measurement model, an examination of the convergent validity, discriminant validity, and reliability tests was carried out, as suggested by Ghozali (2021) and Hair et al. (2019). The convergent validity test requires a loading factor value of more than 0.7, although 0.60 is allowed if the research is exploratory. In addition, the Average Variance Extracted (AVE) and communality values must be more than 0.5. The discriminant validity test uses the Fornell-Larcker criterion, which states that the square root of AVE must be greater than the correlation between latent constructs. In addition, the cross loading value must indicate that the loading of the indicator item on the construct is greater than the other cross loading values. The Heterotrait-Monotrait Ratio (HTMT) is also recommended to be less than 0.90. For the reliability test, Cronbach's alpha and Composite Reliability are used, which must be more than 0.7, with 0.60 allowed for exploratory research. In the first stage of convergent validity testing, several construct scores did not meet the established criteria, so they had to be removed from the model. The indicators removed included X1.1 and X1.6 in the Green Innovation construct, indicators X2.1 to X2.5 and X2.7 in the sustainability performance construct, and indicators Y.2, Y.3, Y.4, Y.5, Y.6, Y.8, Y.9, Y.12 and M.9 in the environmental policy construct. After the removal of these indicators, a retest was conducted, and the results met all the established requirements.

Structural model assessment (Iner Model)

Inner Model Evaluation is a test of the structural model which is carried out by looking at the R-Square (R2) value which is a goodness-fit test of the model with criteria of 0.75, 0.50 and 0.25 indicating a strong, moderate and weak model. Effect Size Value$f2$ 0.02, 0.15 and 0.35 which indicate (small, medium and large),2 predictive relevance with criteria of 0.02, 0.15 and 0.35 (weak, moderate and strong) and significance with criteria of t-value 1.65 (significance level = 10%), 1.96 (significance level = 5%), and 2.58 (significance level = 1%) (Hair, 2011). The test results show that the R2 value of sustainability performance is obtained 0.221 included in the weak model and. The R2 value of financial performance is obtained 0.425 included in the moderate model. Furthermore, the effect size value is presented in the following table.

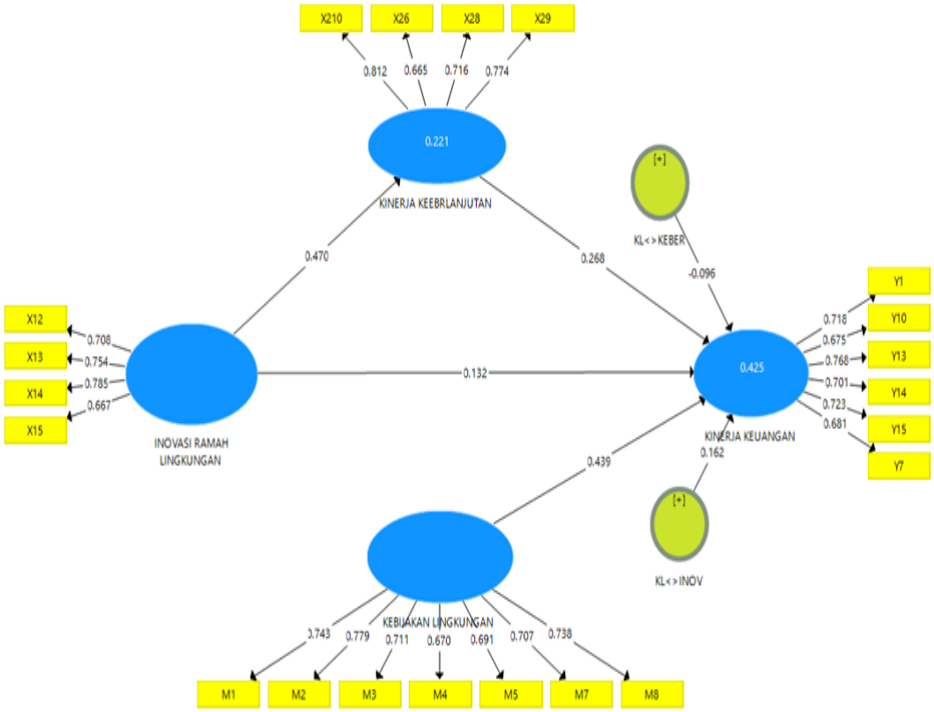

Figure 1. Structural Model of Research

Table 1. Effect Size Test Results

Construct	SP	Caption	FP	Caption
Green Innovation (GI)	0.284	Moderate	0.022	Weak
Environmental Policy (EP)			0.291	Strong
Sustainability Performance (SP)			0.089	Weak
EP<>GI -> FP			0.042	Weak
EP<>SP -> FP			0.014	Weak

Note. GI: Green Innovation, EP: Environmental Policy, FP: Financial Performance, SP: Sustainability Performance

This study uses non-parametric bootstrapping with 5,000 replications (Hair et al., 2019). The results of the significance test of the direct effect hypothesis, indirect effect (mediation) and moderation are presented in tables 2 below:

Table 2. Results of the Significance Test of the Direct, Mediation and Moderation Effect Hypotheses

Path Analysis	Hypothesis	Coefficient	T Statistics	P Values	Information
Direct					
GI -> FP	H1	0.132	2,473	0.007	Supported
GI -> SP	H2	0.470	10,540	0,000	Supported
SP -> FP	H3	0.268	5,597	0,000	Supported
EP -> FP	H4	0.439	9,813	0,000	Supported
Moderation					
EP<>GI -> FP	H6	0.162	3,012	0.001	Supported
EP<>SP -> FP	H7	-0.096	2,045	0.021	Supported
Mediation					
(Specific Indirect Effects)					
GI -> SP -> FP	H5	0.126	5,441	0,000	Supported

Note. GI: Green Innovation, EP: Environmental Policy, FP: Financial Performance, SP: Sustainability Performance

The Impact of Green Innovation on Financial Performance

The results of the H1 test show that green innovation has a positive effect on the company's financial performance. The RBV theory states that unique and valuable resources can provide competitive advantages. Green innovation can be considered a strategic resource that can improve operational efficiency and reduce costs, there by contributing to improved financial performance. This innovation includes the application of green technology, waste reduction, and increased energy efficiency, which contribute to improved financial results. This study supports the findings of Du & Wang (2022) and Akhtar et al. (2024), which show that green innovation reduces production costs and increases profit margins. Engelman et al. (2017) also found that this innovation improves the company's reputation, expands market share, and increases consumer loyalty. In addition, Fang et al. (2022) emphasized that companies that innovate sustainably can take advantage of government incentives, especially in countries with strict regulations. Overall, green innovation helps companies reduce environmental risks, improve efficiency, strengthen their image, and create new market opportunities, which support improved long-term financial performance.

The Impact of Green Innovation on Sustainability Performance

The results of the H2 test show that green innovation has a positive impact on sustainability performance. The RBV theory states that unique and valuable resources can provide competitive advantage. Green innovation can be considered a strategic resource that can improve operational efficiency and reduce costs, thereby contributing to improved financial performance. This innovation involves the development of technologies and processes that reduce environmental impacts while improving operational efficiency. The findings of this study are in line with the studies of Chen et al. (2020), Zhang et al. (2021), and Li et al. (2022), which confirm that green innovation strengthens sustainability performance and provides competitive advantage. In addition, Dangelico and Pontrandolfo (2023) show that this innovation, especially in the manufacturing sector, contributes to reduced emissions, increased energy efficiency, and better financial performance.

The Impact of Sustainability Performance on Financial Performance

The results of the H3 test show that sustainability performance has a positive effect on the company's financial performance. The Triple Bottom Line theory emphasizes that companies must consider three aspects: economic, social, and environmental. Companies that adopt green practices tend to be more sustainable, which can increase profitability and investment attractiveness. Companies that focus on sustainability aspects (ESG) not only maintain environmental and social balance but also increase profitability and long-term competitiveness. This study supports the findings of Ren et al. (2024), which states that improving ESG performance has a significant impact on green innovation and financial performance. Mahmoudian et al. (2022) emphasize that focusing on social and environmental sustainability increases global competitiveness, especially through stakeholder attention. Overall, sustainability performance helps improve a company's image, public trust, and financial growth by reducing operational risks and improving reputation in the market.

The Impact of Environmental Policy on Financial Performance

The results of the H4 test show that the implementation of environmental policies has a positive impact on the company's financial performance. Legitimacy theory explains that companies strive to obtain and maintain legitimacy from society and stakeholders. By implementing sustainable policies, companies can strengthen their legitimacy, which can have a positive impact on financial performance. Well-implemented environmental policies improve reputation, operational efficiency, and reduce long-term financial risk. This study is

in line with Liu's (2024) findings which state that companies that comply with strict environmental policies experience increased financial performance through reduced operational costs and avoidance of litigation risk. Du & Wang (2022) also emphasized that proactive policies, such as reducing emissions, provide benefits in the form of government incentives and increased ESG investment. Ren et al. (2024) added that environmental policies support green innovation, which expands markets and increases efficiency. Overall, effective environmental policies reduce negative impacts on the environment and increase the company's long-term profitability, efficiency, and competitiveness.

The role of sustainability performance in mediating the influence of green innovation on financial performance

The results of the H5 test indicate that sustainability performance serves as a mediator in the relationship between green innovation and financial performance. Green innovation, including the adoption of better technologies and practices for the environment, can improve energy efficiency and reduce negative impacts. However, its impact on financial performance is indirect and depends on the implementation of sustainability principles by the company. Sustainability performance that includes environmental, social, and governance (ESG) aspects strengthens this relationship by building reputation, reducing costs, and increasing customer loyalty. Several studies have shown that companies that focus on sustainability have a competitive advantage and better financial results, because sustainability performance helps maximize the impact of green innovation (Fang et al., 2022; Popa et al., 2022; Akhtar et al., 2024; Srouji et al., 2023).

The Influence of Environmental Policy in Moderating the Relationship between Green Innovation and Financial Performance

The results of the H6 test show that environmental policies can strengthen the relationship between green innovation and financial performance. Legitimacy theory argues that companies need to gain support and recognition from stakeholders to operate effectively. In this context, legitimacy is obtained by meeting social and environmental expectations set by society, government, and various other stakeholders. Environmental policies implemented by governments or regulatory agencies serve as norms that guide corporate behavior. When companies adapt to these policies and implement sustainable practices, they demonstrate a commitment to social and environmental responsibility. Thus, companies can strengthen their legitimacy in the eyes of stakeholders. By integrating environmental policies into innovation strategies, companies not only increase their social responsibility but also create sustainable economic value, strengthening the relationship between green innovation and financial performance. The results of this study support the findings of previous studies such as Parker & Guthrie (2021), Ioannou & Serafeim (2022), and Halkos & Jones (2023) which revealed that proactive environmental policies encourage investment in green innovation, improve corporate reputation, cost efficiency, and long-term profitability.

The Influence of Environmental Policy in Moderating the Relationship between Sustainability Performance and Financial Performance

The results of the H7 test show that environmental policies can strengthen the relationship between sustainability performance and financial performance. Legitimacy theory argues that companies need to gain support and recognition from stakeholders to operate effectively. In this context, legitimacy is obtained by meeting social and environmental expectations set by society, government, and various other stakeholders. Environmental policies implemented by the government or regulatory agencies serve as norms that guide corporate behavior. When companies adapt to these policies and implement sustainability practices, they demonstrate a commitment to social and environmental responsibility. Thus, companies can strengthen their legitimacy in the eyes of stakeholders. The results of this study indicate that environmental policies strengthen the relationship between sustainability

performance and financial performance, supported by legitimacy theory. These policies help companies meet social and environmental expectations, strengthening legitimacy in the eyes of stakeholders. By encouraging sustainability practices, companies can reduce risks, costs, and improve their reputation and investor appeal. The findings of Ehsan et al. (2023) and Jiang et al. (2022) support that good environmental policies help companies achieve better stock performance and financial stability.

Conclusion

This study found that green innovation, sustainability performance, and environmental policy directly affect financial performance. Sustainability performance acts as a mediator in the relationship between green innovation and financial performance, while environmental policy moderates this relationship. These findings support stakeholder theory, legitimacy theory, and Resource-Based View (RBV) theory, asserting that the integration of green technology and practices can improve financial performance. Implications: 1) Theoretical: The findings extend the literature on financial performance through green strategies. Stakeholder management is an important factor in improving financial performance and sustainability. 2) Practical: Companies should focus on sustainability strategies, involve stakeholders in the decision-making process, and adopt green technologies to improve efficiency, manage risks, and enhance reputation. 3) Policy: Policymakers need to support green innovation with a clear regulatory framework and provide incentives for companies investing in green technologies. Collaboration between the government, companies, and the community can improve sustainability practices, while education and training programs should be encouraged to raise awareness of the importance of sustainability. Recommendation: Further research can expand the scope of the area outside Bali to increase the generalizability of the findings. In addition, measuring the financial performance of SMEs needs to be more objective by using indicators such as revenue growth, profitability, and cash flow, in order to produce a more comprehensive study.

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