# CHAPTER I

## INTRODUCTION

### 1.1 Research Background

The evolution of technology, information, economics and much more in this era has led to the emergence of a growing mindset which resulted in the rise of new ideas. As the embodiment of these ideas, many new companies were built and triggering the competition between companies in the economic environment. So, the company leaders should be capable of carrying out and manage every activitiy carried out as effectively and efficiently as possible. Therefore, to be able to remain competent with each other's, a company needs a source of support as a driving force for company activities or in other words "Capital". Capital is one of the most important things for a company. In supporting all activities that occur within the company such as production activities, manufacturing, marketing, distribution, and others to achieve the vision, mission, and goals. Capital plays a big role in the sustainability of a company in developing and maintaining their businesses so that it continues to run. Capital obtained by the company is not given for free. In obtaining capital the company will also get a cost of capital. Cost is the amount of inputs acquired in producing a product measured in numerical terms that estimated on actual amount expended on producing a particular commodity (Olajide et al., 2016).

It can be defined that cost is an amount that must be paid to buy or obtain something. By understanding the meaning of capital and costs separately, it can be concluded that the cost of capital is the cost which must be incurred or paid by the company as the consequence to get the capital that is used by the company.

A company uses various sources as their capital source. If there is only one source of capital, it is not difficult to find out the cost of capital. However, with various types of business activities carried out, the company certainly require large amount of capital, and that amount can't be obtained from only one source but from many sources of funds. Because of the capital that a company uses comes from various sources of existing capital, therefore the weighted average cost of capital or WACC, used by company to calculate its cost of capital. Most companies obtain their funding from both debt and equity, WACC represent the costs of obtaining part of total capital from equity and the remainder from debt or other sources (Growth & Anderson, 1997).

WACC shown in the form of a ratio that explain about the cost that needs to be paid by the company to the providers of capital funding based on calculations from the weighted average level of after-tax cost of debt from the company's capital sources including the preferred stock, common stock, bonds and other long-term debt. From company's perspective, cost of each source of capital indicates the rate of return that those sources' providers demand (Shubber & Alzafiri, 2008). The result of WACC can help company and the investor in decision making. Because WACC provides information about the

actual cost of capital of a company by considering every component involved. Companies with a high WACC value can be interpreted that it has high costs to be paid in the use of its capital. WACC can be used as one of the calculations that can measure the risk ratio and bankruptcy (Koziol, 2014). The relationship WACC and company's financial risk is positive, it implies that when the WACC rises, so does the company's financial risk. Investors can use this as a consideration to help them for investing in a company.

For the company itself, one of the benefits of WACC is as a basis for decision making for new project resources. The company's management can use the cost of capital calculation as a reference to concentrate on the capital structure's composition. Of the company by decreasing their funding through debt to decrease company capital costs and financial risk (Wananda et al., 2021). To implement a new project, the company needs more capital and WACC calculation can help the company in designing the optimal capital structure to carry out the project. The new project needs to generate a higher required of return than the value of WACC so that the company can generate more profit because the project generated more money and exceeded the previous cost of capital and will not increase its WACC value. Therefore, the WACC reflect the company's financial performance by showing their ability in managing their source of capital.

By adjusting its capital structure to lower WACC, one of the company main goals is to generate profit as much as possible. One of the goals that is maximizing profits in the long term by utilizing the available resources as

efficiently and effectively as possible. In response, company need to have a good performance. Because with good company performance, companies can provide good value of stock returns for shareholders and also increase company value. Companies is always competing to generate more profits in order to develop their company as their main goal. The more the company develops, the more activities happen within the company to produce products and services. However, to achieve this goal, sometimes companies ignore the impact they cause in order to generate large number of profits. The company's management of its resources becomes uncontrollable and causes damage and even harm the community. This uncontrollable use of resources damaged the environment which will affect to society's lives and the side effects given will disrupt the entire community environment or socially.

All actions taken by the company will have an impact on the community environment. Therefore, in carrying out its operational activities, companies also need to be responsible for the environment and social so they get support and trust from the surrounding community in running their business (Adrianto et al., 2019). The trust and support obtained from the community can have a positive impact on the life supporters of the company in the future (Gray et al., 1995). With that the company began to consider their sustainability development by publishing the sustainability report.

"Sustainable development and sustainability reporting have been deemed as important aspects of the economy that can be seen from the increasing research about the impact of sustainability on company's performance" (Junius et al.,

2020). As one of the strategies used to attract investors, a sustainability report is published by the company. Sustainability report is an important aspect for the company. It is one way that companies can do to protect the interests of each party. The report describes the organization's performance and effects on a variety of sustainability issues, including environmental, social, and governance factors. The company will share transparent information about its position and activities on the economic, environmental, and social aspects by publishing a sustainability report. The published sustainability report can be access by every party for their own interests. Especially for the investors who are considering environmental and social issues, where they prefer to support companies with good sustainability performance by investing in these companies. Therefore, the availability of environmental, social, and governance (ESG) indicators make investors to be more interested in making a socially responsible investing decisions as a result of the global community's shifting attitudes toward sustainability challenges (de Lucia et al., 2020).

There are many types of data in the sustainability report that are used as a reference for investing. Where one of them is the data on environmental, social, and governance (ESG) of the company. The assessment of these three ESG factors associated to the sustainability of the company, as the environmental factor issues are natural climate change, environmental impacts and environment protection resulting from the business operation. Human rights, equality, workplace diversity, and social participation are the major topics of the social factor. Lastly, the governance factor concerns about the board

independence, ownership structure, equitable shareholders treatment, transparency, minority stakeholder rights and corporate information disclosure (Atan et al., 2018).

These three ESG pillars have different meanings which still be based on the idea of sustainable development. In accordance with the name of each pillar in ESG, each pillar focuses on their respective sectors. The environmental pillar includes the company's contribution to various environmental factors around it such as energy use, waste handling, pollution, and company behavior towards flora and fauna. Seeing how people's efforts in fighting global warming, emission reduction and decarbonation are important for the world today, investors use this environmental factor in assessing the company's performance in an environmentally friendly manner. Companies with the fulfillment of these environmental criteria will be having a positive impact on society, the environment and the company itself (Putra & Adrianto, 2020). The company will receive support from the society as a form of appreciation in paying attention to environmental life, and also helping sustainability in its business operations.

In addition to paying attention to the surrounding environment, companies must also pay attention to the surrounding social conditions. The social aspect in ESG discusses the company's relationship with internal and external social parties such as employees, local communities, buyers, suppliers, and other entities in the company environment. A company's capacity to generate trust and loyalty among its employees, customers, and communities is

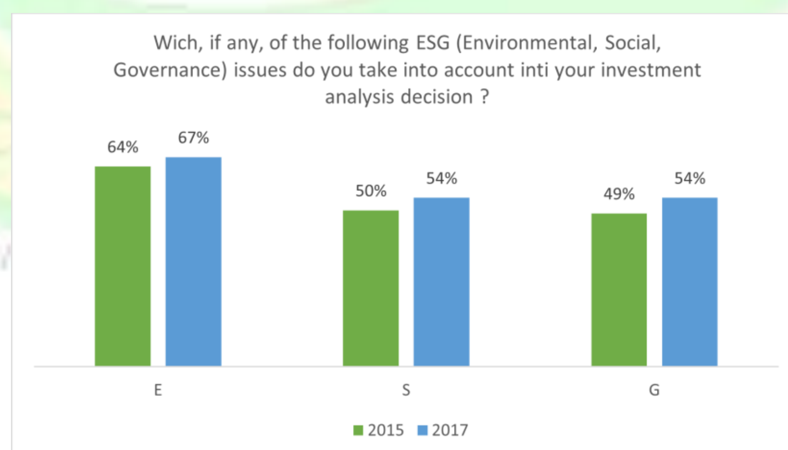
measured by its social pillar score (Velte, 2017). In paying attention to social circumstances, it is very important for companies to establish good relations with internal and external parties. Internally, companies must think about the social welfare of their employees or other stakeholders. This includes human rights such as the health and safety of workers, the fulfillment of labor standards, or the handling of the rights and constraints of workers. Meanwhile, the most important social responsibility to external parties of the company is to have a social permit to operate. This social permit is carried out with an approach to the surrounding community by the company. A well-integrated company relationship with the local community can increase social value, where cooperation has been established between the company and the surrounding community.

The last pillar in ESG is Governance. Unlike environmental and social criteria that focus on the surroundings of both society and nature, governance focuses on good and sustainable management in the company's internal activities. A set of regulations or principles that explain the duties, responsibilities, and expectations of various parties participating in board composition are referred as "governance". Measurement of a company's systems and processes to make sure that executives and the board of directors behave in the long-term shareholders' best interests (Velte, 2017). By having a good governance per the value of governance will increase and attract the attention of investors. By providing good governance information, it reflects that there is good internal management in terms of company policies, standards,

information disclosure, financial audit processes and compliance. This transparent information increases investor confidence in the company and is used as a basis for making its investments.

In 2015 and 2017 the CFA Institute conducted a survey of investors regarding the most widely used factors in ESG in considering investment decisions with a total of 47.208 respondents who are portfolio managers and research analysts. From the survey in 2017 results, 73% of respondents take ESG issues into their account with governance factors as the highest choice, while 27% of other respondents do not take ESG factors into consideration. This data has the same result in 2015, the difference is located on each factors results. With governance options as the most considered factor, the results in 2017 increased by 3% compared to 2015. For environmental factors it increased by 4% and social factors increased by 5%. The survey results can be seen below:

**Figure 1.1 ESG Issues Importance in Investment Analysis Decision**




Source: CFA Institute, 2017

Overall, the number of respondents has also increased, however, this can show that more and more investors are starting to consider the ESG factor in their investment decisions. The development of ESG in Indonesia itself is still relatively new, where the awareness of companies in Indonesia in publishing sustainable reports only increased rapidly in 2016 with a total of 120 companies where previously there was only one company with a sustainability report in 2005 (Tsalatsa, 2018). With the development of the issuance of this sustainability report, the Indonesian stock market has begun to realize and pay attention to its impact on investment decisions as well as its impact on society. In 2019, the Center for Risk Management and Sustainability (CSMR) conducted a national survey on ESG in Indonesia. The survey was attended by 171 respondents who are professionals and practitioners with positions in organizations in different types of industries. One of the surveys conducted was regarding the perception of professionals in Indonesia from various types of industries towards ESG. The results of the survey can be seen in the image below:

**Figure 1.2 The Perception on ESG**

Source: (Center for Risk Management & Sustainability (CRMS), 2019)

As can be seen from the data above, majority of the respondents that are 86.6% think that ESG is important. With the 66.1% of respondents for the reason that ESG is important because it supports the sustainability of the organization. The conclusion that can be drawn from this information is that ESG has become a concern for industries in Indonesia in supporting the sustainability of companies.

With this enthusiasm for ESG which can reduce the company's negative impact on the social and environment as well as providing information on safe corporate governance, the Indonesia Stock Exchange has begun to respond by launching several ESG stock indexes. Quoted from the Index on the Indonesia Stock Exchange (IDX) where there are 3 ESG stock indexes, namely IDX ESG Leaders, ESG Quality 45 IDX KEHATI, and ESG Sector Leaders IDX KEHATI. These three indexes provide information on listed companies with good ESG performance ratings. With the publication of this ESG index, it is hoped that IDX can provide investors with a company classification with a good ESG Score.

With this trend on ESG, several research have been carried out to study how sustainability reports affect business performance, particularly the cost of capital. Study conducted by Atan et al. (2018) which argues that the individual ESG (E, S, and G) scores does not affect the cost of capital (WACC), even though the overall ESG score does have a positive and significant impact. The

same goes with the study conducted by Piechocka-Kałużna et al. (2021) that find out about ESG scores as a whole and individually showing a significant effect and has a negative relationship. From the results of these previous studies, it can be concluded that the ESG score significantly affects the Weighted Average Cost of Capital (WACC) although it has a different relationship (positive and negative).

Besides the trend in ESG performance disclosure that is currently developing among investors, one of the factors that also influences investors' decision making is regarding shariah compliance of companies. From IDX, it can be seen the list of companies that follow Islamic sharia compliance through 4 indices. Those indexes namely the Indonesia Sharia Stock Index (ISSI), Jakarta Islamic Index (JII), Jakarta Islamic Index 70 (JII70), and IDX-MES BUMN 17.

Sharia-compliant products must comply to three principles of Islamic law, such as the limitations on Riba, which defined as a condition imposed by the lender where there is unjustified increase in borrowing or lending money that is paid above the amount of loan, unclear contracts (Gharar), or business activities involving products or services that are unethical (Shariff et al., 2021). According to *Otoritas Jasa Keuangan* (OJK), the concept of sharia compliance is a company that follows sharia principles as seen from its financial ratios, one of the principles which is the total interest-based debt to total equity ratio is below 82%. Another sharia principle that must be obeyed are that the company does not contain elements of interest-based financing or usury, does not engage

in gambling activities or sell goods or services that are unlawful. One of the types of research on sharia principles is by Miglietta & Battisti (2016) who concludes in the results of the research, that companies listed on the Malaysian stock exchange that use shariah compliance have a higher WACC value. This is confirmed by studies revealed by Satt et al. (2020) that stated the level of sharia compliance has positively effects on the cost of debt. This increase in the cost of debt will indirectly increase the cost of capital (WACC) that possibly caused by requirements in the use of credit regulated in sharia principles.

There is a lack of research on the relationship between ESG performance and companies that comply to shariah principles towards the cost of capital (WACC). Many studies concentrate more on the relationship between ESG performance towards financial performance as assessed by return on equity, return on assets, and Tobin's Q of the company. Due to the lack of previous studies, in this study the author tries to show the relationship between ESG performance and companies with sharia compliance with WACC. Therefore, this study will discuss about **"The Effect of Environment, Social, Governance Performance and Syariah Compliance Towards the Weighted Average Cost of Capital (WACC) of Company Listed on Indonesia Stock Exchange (IDX)"**

### 1.2 Research Question

Based on the background above, the following problems can be identified as follow:

1. How does the environmental performance effect on company's Cost of Capital through the environmental score?
2. How does the social performance effect on company's Cost of Capital through the social score?
3. How does the governance performance effect on company's Cost of Capital the governance score?
4. How does the ESG performance affect companies that apply shari'ah compliance toward Cost of Capital?

### 1.3 Objective of The Research

Based on the formulation of the problems above, the objectives of this study are as follow:

1. To find out the effect of Environmental I performance effect on company's Cost of Capital through the environmental score.
2. To find out the effect of Social (S) performance effect on company's Cost of Capital through the social score.
3. To find out the effect of Governance (G) performance effect on company's Cost of Capital through the governance score.

4. To find out effect of ESG performance affect companies that apply shariah compliance toward Cost of Capital.

**1.4 Benefits of The Research**

By the implementation of this research, the result of this study is expected to be beneficial for several parties, both theoretically and practically. Here is the description of the research benefits:

1. Theoretical Benefits.

This research is expected to provide more insight and knowledge about the importance of ESG performance and the use of sharia compliance in their effect on the cost of capital (WACC) in companies listed on the Indonesian Stock Exchange (IDX).

2. Practical Benefits.

a) For the researchers.

This research is expected to be useful as a tool in implementing the author's knowledge about sustainability development, ESG factors, shariah compliance, and also cost of capital.

b) For academics and future researchers.

This research is expected to be used as a recommendation for the academics to contribute to the development of research on the importance of ESG and shariah compliance for company performance and as a reference material for future researchers.

c) For companies.

This research aims to provide information on the importance of sustainable development in companies by paying attention to environmental, social, and corporate governance factors that affect the cost of capital (WACC).

d) For investors.

This research is expected to provide information and be a reference in making investment decisions by considering environmental, social, and governance factors expressed in the ESG score as an analytical tool to see its effect on the cost of capital (WACC).

e) For government.

This research is expected to provide an overview to the government to start paying attention to sustainable developments in the company and establish rules and policies for the company to pay more attention to environmental, social, and corporate governance factors.

**1.5 Scope of The Research**

In this study, the research analyzes the impact and relationship of ESG score and shariah compliant towards Cost of Capital (WACC). To carry out this study, the data uses are ESG score and WACC for four periods starting from 2015 until 2019, published by analytical company that is Refinitiv Eikon from companies listed on Indonesia Stock Exchange.

## 1.6 Research Systematics

The systematic of writing in this study are made to provide a comprehensive picture of research. The writing of this research consists of five chapters, using the systematics as follows:

CHAPTER 1: INTRODUCTION

Chapter 1 contain of background of the problems, problem formulation, research objectives, research benefits, scope of the research, and systematics writing.

CHAPTER 2: LITERATURE REVIEW

Chapter 2 contain of the explanation of the theoretical foundation as the base of this research. The theoretical foundation obtained from previous research that are relevant and related. In this chapter will also discussed about the hypothesis development and conceptual framework.

CHAPTER 3: RESEARCH METHODOLOGY

Chapter 3 discusses the research methods that include research design, population, and research samples, data types, data collection methods, variables identification and data analysis technique.

CHAPTER 4: RESULT AND DISCUSSION

Chapter 4 discuss the result of the research that contains of the description of data, data analysis, and interpretation of the research result.

CHAPTER 5: CONCLUSION

Chapter 5 as the last chapter contain the conclusion from the research that has been done, research implications, research limitations and suggestion for future research.