CHAPTER I

INTRODUCTION

1.1 Background

Investment activity is an activity carried out by investors, whether companies or individuals, with various risks and uncertain of future profits. The company's investment is projected to boost its business growth because it considers both the rewards and hazards that will be realized in the future. Companies must appropriate investments to achieve efficiency. The incremental capital-output ratio is a ratio that can be used to measure investment efficiency. ICOR is a measure of inefficiency in the economy, especially in investment. A high ICOR value indicates investment inefficiency (Sipahutar, 2020).

Indonesia is experiencing investment inefficiencies based on Indonesia's high ICOR. From 2019-2022 Indonesia's ICOR tends to be higher than the average ICOR of several ASEAN countries. The average ICOR of ASEAN countries is in the range of 3-4. ICOR can be one of the parameters to indicate whether a country is good for investment. In 2019 Indonesia's ICOR reached 6.77, worse than in 2018, which was 6.44. In comparison, the ICOR neighboring countries are lower: Philippines ICOR is 3.6, Malaysia 5, Vietnam 4.1, Thailand 6, and India 4.2 (Ipotnews).

Efficient investment uses company assets appropriately. The efficient investment ensures no wastage of existing resources so that costs are reduced and can manage the company optimally to achieve profitability. When there is underinvestment or overinvestment, which refers to investment that are over or

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under optimal value, respectively, an investment is said to be inefficient (Biddle et al., 2009; Ullah et al., 2020). One of the criteria that companies can use to make investment decisions is to use net present value (NPV). The manager will assess the NPV of the investment project offered. If the company undertakes a project with a positive NPV without market frictions such as agency costs or adverse selection, then the company is investing efficiently.

Overinvestment conditions occur when the company is too excessive or exceeds the predetermined investment target. A company with problems with overinvestment, in general, is a company that is in the mature stage with a slow growth rate and has assets in place and high free cash flow (Dwiwana, 2012). In comparison, the condition of underinvestment is the need for more investment made by the company. The company only carries out some projects known to benefits the company. The conditions of underinvestment arise when the company faces investment opportunities in projects with high NPV. Investment below the expected level is considered as underinvestment or negative deviation. In comparison, investment above the expected level is regarded as overinvestment or positive deviation. (Majeed et al., 2018).

The investment decisions taken affect whether or not an investment is efficient. Investment decisions made by companies require the role of a manager and investor or shareholder to create investment efficiency. Managers have a role in deciding and analyzing how to take advantage of available investment opportunities. Meanwhile, shareholders also have a role so that there is no opportunistic behavior of managers in making decisions. Therefore, a balance of

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information about the company’s state between shareholders and managers should be created. However, efficiency or inefficiency of an investment can be influenced by the decisions taken by the company’s management. There is an interest conflict between shareholders and management, and a lack of manager oversight mechanisms, which may lead managers to seek to maximize their welfare to the detriment of shareholders (Jensen & Meckling, 1976). Managers or parties within the company have better access to information to get more about company prospect information that is not owned by outsiders, thus providing opportunities for management to manipulate the financial information they know (Manggau, 2016). Although it has extensive information about the value of the investment, the manager may instead take advantage to choose an investment that favors itself at the expense of shareholders' or principals' interests (Suman & Singh, 2021). Management shows opportunistic behaviors because it prioritizes its prosperity over shareholders in investment decisions (Suman & Singh, 2021). Based on agency theory, the company's initial investment goals can't be realized because of information asymmetry among stakeholders, that is, to improve the welfare of investors or shareholders. If companies increase transparency in presenting information, it can facilitate better monitoring of manager’s investment decisions (Roychowdhury et al., 2019).

In recent years, ESG practices have received much attention in various circles, such as the business community and academia (Arif et al., 2020). Companies are pressured to face significant stakeholder demands, namely increasing, going beyond mandated ESG level activity, and improve financial performance (Eliwa et al., 2021). Companies in the largest global financial markets

boosted their SRI by 14.37%, from US$30.6 trillion in 2018 to over US$35 trillion in 2020, illustrating increased interest in integrating ESG criteria into business practices by stakeholders (Bloomberg, 2022). The jargon "what is good for the business is good for society" is no longer applicable in a modern business environment, the reverse is that "what is good for the world or society is now good for the business (Al-Hiyari et al., 2022).

ESG disclosure is crucial for meeting investor demand and proving that a company is following non-financial disclosure best practices like GRI (Ellili, 2022). ESG also often benefits to various stakeholders and is a component of a company's success. Based on a PWC survey, 79% of worldwide shareholders think companies should explicitly incorporate ESG into their business operations and strategies. The survey results align with stakeholder, where companies must be financially and non-financially responsible to other stakeholders. The company's ability to survive hinges on how the company manages relationships with customers, employees, investors, suppliers, society, community, and others as well as the support from stakeholders. Environmentally responsible companies are well regarded as fulfilling non-financial obligations.

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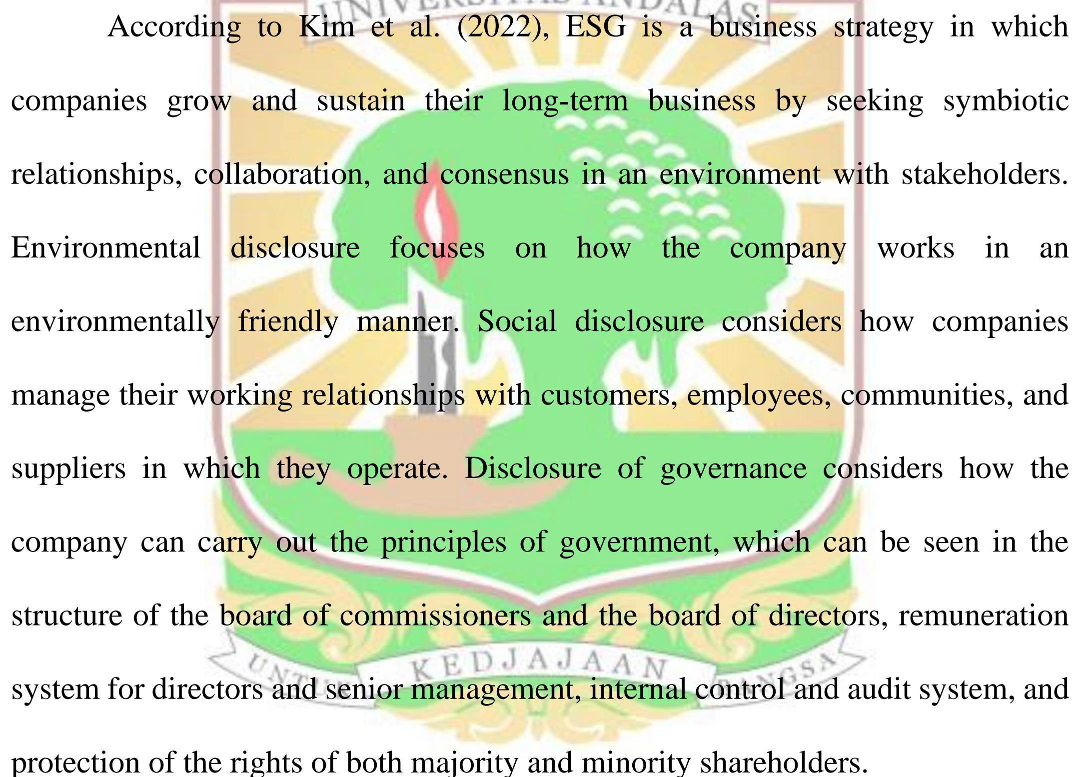
One way for companies to be aware of sustainability is by reporting ESG. The basic concept of ESG implements development activities, business continuity, and investment with three pillars namely environmental, social, and governance. The Schroders global investor study for 2022 states that people's awareness of investing in products with sustainable principles is starting to increase because investors in Indonesia are interested in getting into sustainable investment funds

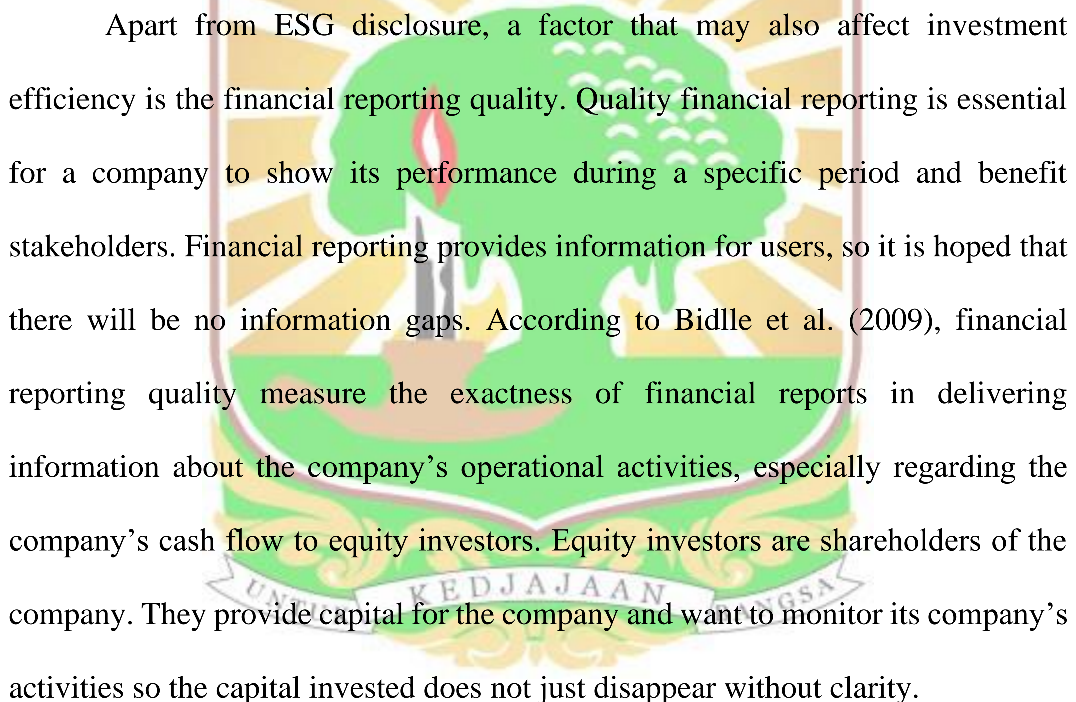
partly for environmental reasons. The annual study surveyed more than 23.000 people in 33 global locations, including Indonesia, and found that 54 percent of Indonesian respondents were attracted to sustainable investment funds of their wider environmental impact. Meanwhile, 58 percent of respondents also said sustainable investment funds were considered attractive because of their societal principles. The survey study results show that in compiling investment portfolios, sustainable investment has become an option worldwide and in Indonesia.



According to Kim et al. (2022), ESG is a business strategy in which companies grow and sustain their long-term business by seeking symbiotic relationships, collaboration, and consensus in an environment with stakeholders. Environmental disclosure focuses on how the company works in an environmentally friendly manner. Social disclosure considers how companies manage their working relationships with customers, employees, communities, and suppliers in which they operate. Disclosure of governance considers how the company can carry out the principles of government, which can be seen in the structure of the board of commissioners and the board of directors, remuneration system for directors and senior management, internal control and audit system, and protection of the rights of both majority and minority shareholders.

Of the many literatures that discuss ESG, only a few discuss why managers choose to invest in activities about ESG and whether they are profitable. Stakeholder theory shows that a company's commitment to ethical and moral behavior is reflected in ESG and high ESG involvement can also increase company value (Benlemlih & Bitar, 2018). Superior financial performance improves the

company's image and competitiveness, which has been documented by previous literature and can be realized by preserving positive interactions with stakeholders (Hichri & Ltifi, 2021). To defend legitimacy with the business community, managers can symbolically adopt ESG practices (Liao et al., 2019). Therefore, self-serving managers can gain personal benefits by adopting greenwashing policies on ESG practices at the expense of stakeholders (Al-Hiyari et al., 2022). As a result, the ESG practices and the economic impacts of companies are hotly controversial and debated. (Al-Hiyari et al., 2022).

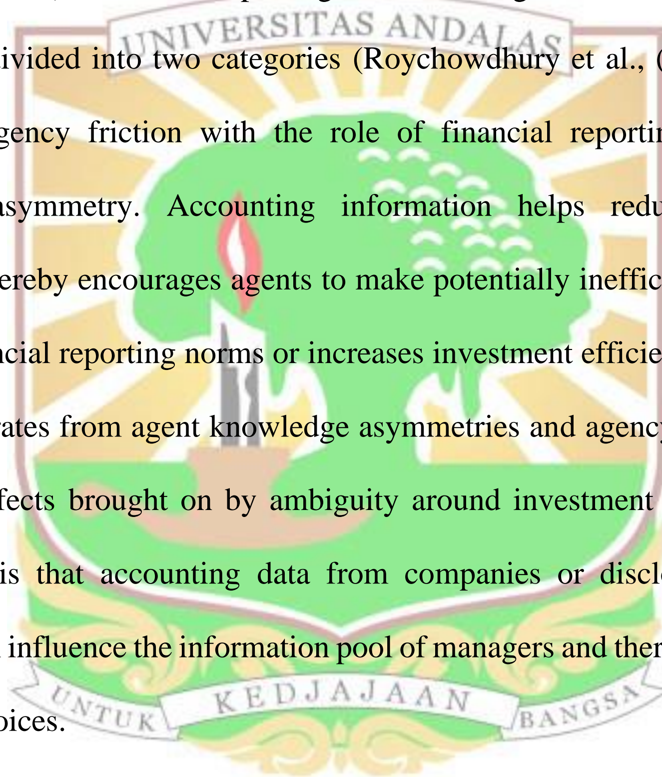


Apart from ESG disclosure, a factor that may also affect investment efficiency is the financial reporting quality. Quality financial reporting is essential for a company to show its performance during a specific period and benefit stakeholders. Financial reporting provides information for users, so it is hoped that there will be no information gaps. According to Bidlle et al. (2009), financial reporting quality measure the exactness of financial reports in delivering information about the company's operational activities, especially regarding the company's cash flow to equity investors. Equity investors are shareholders of the company. They provide capital for the company and want to monitor its company's activities so the capital invested does not just disappear without clarity.

When information asymmetry, adverse selection, moral hazard, and agency issues are reduced, financial reporting quality affect investment efficiency. Improving the financial reporting quality helps lessen the knowledge gap between manager and stakeholders (L. W. Wang et al., 2019; Houcine et al., 2022). Potential investors and other users can use high-quality financial reporting information.

Financial reporting with high-quality will facilitate supervision to lessen information asymmetry.

The quality financial reports can provide appropriate information in making decisions, including investment decisions. Disclosures can provide additional information to stakeholders and help them make the best possible investment decisions, forming the basis for maintaining regular investment operations (L. W. Wang et al., 2019). Financial reporting in influencing investment decisions and efficiency is divided into two categories (Roychowdhury et al., (2019). The first category is agency friction with the role of financial reporting arising from information asymmetry. Accounting information helps reduce information asymmetry, thereby encourages agents to make potentially inefficient investments to satisfy financial reporting norms or increases investment efficiency. The second category separates from agent knowledge asymmetries and agency issues in favor of learning effects brought on by ambiguity around investment possibilities. Its main feature is that accounting data from companies or disclosed by similar companies can influence the information pool of managers and thereby change their investment choices.



In addition, Investment efficiency can also improve with the quality of financial reports and the possibility for a company leader to make an investment project recognition honestly to make a decision (Elaoud & Jarboui, 2017). Better financial reporting quality makes investment operations more transparent and lessens adverse selection when issuing securities, which enables businesses with limited resources to withdraw funds more effectively. The findings obtained from

Roychowdhury et al. (2019) implied that better financial reporting influence managers to increase investment efficiency. In addition, better financial reports can limit managerial authority to invest excessively and improve investors' ability to observe their investment activities (Zhong & Gao, 2017).

Better quality financial reporting will have an impact on better oversight to minimize the occurrence of overinvestment and underinvestment. According to McNichols and Stubben (2008) improving to the good quality of financial reporting can minimize information asymmetry because this will increase the capability of external parties to track management performance. So, if investment efficiency is associated with better-quality financial reporting, the problems of underinvestment and overinvestment will decrease. So that businesses can prevent overinvestment and underinvestment situations, the quality of financial reporting is required to lower the incidence of information asymmetry between stakeholders, including internal and external parties.

Some research on ESG disclosure and financial reporting quality has been carried out to provide empirical evidence regarding its relationship with investment efficiency. Research showing a positive and significant association between ESG disclosure and financial reporting quality on investment efficiency includes research conducted by Ellili (2022). This influence is related to the adherence to ESG disclosure not only reducing information asymmetry and increasing company transparency but also increasing investment efficiency. Aji Aryonanto & Dewayanto (2022) finds that the efficiency of investments is unaffected by ESG disclosure. In addition, the results of this research contradict with agency theory. It

can occur because of the high cost of disclosing ESG, so companies consider disclosing ESG is an act of investment inefficiency.

Based on the background of the problems and previous existing studies, the results of the research conducted are not the same. These contradictory results indicate that further research is still needed to analysis the relation between ESG disclosure and financial reporting quality on investment efficiency. In general, many studies only discuss the effect of financial reporting quality on investment efficiency, while the effect of environmental, social, and governance (ESG) disclosure on investment efficiency is still rare in Indonesia. Previous research on the impact of non-financial disclosure and quality of financial reporting and non-financial disclosure on investment efficiency is almost the same as this study. This study fills various gaps in previous studies on ESG disclosure by existing literature. First, by thinking of ESG disclosure as an all-inclusive non-financial disclosure that covers governance, social, and environmental issues as well as CSR. This research is further from previous studies, which only discussed the effect of CSR disclosure on investment efficiency. Second, although other studies looked at various effects like cost of capital, debt, and financial performance, this research focuses on the unique possible impact investment efficiency from ESG disclosure.

1.2 Research Questions

Based on the background above, the following problems will be discussed in this research:

1. Does environmental, social and governance (ESG) disclosure affect investment efficiency?

2. Does financial reporting quality affect investment efficiency?

1.3 Research Objectives

Based on the formulation of the research problem stated before, the objectives in this research are as follows:

1. To examine the effect of environmental, social and governance (ESG) to the investment efficiency.
2. To examine the effect of financial reporting quality to the investment efficiency.

1.4 Research Benefits

The researcher expects that the result of this study could be used:

1. The results of this research are additional empirical evidence about the effect of ESG disclosure on investment efficiency.
2. The results of this research are additional empirical evidence about the effect of financial reporting quality on investment efficiency.
3. This research is expected to be useful as a reference and research development material for further researchers.

1.5 Writing Systematics

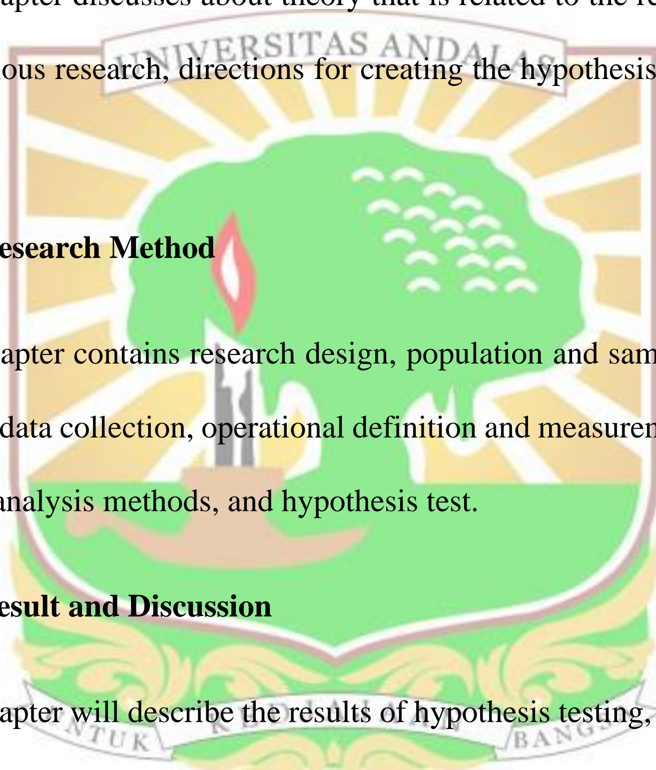
This research will be arranged systematically into five chapters, which will be set as follows:

Chapter I Introduction

This chapter discusses the general description on which the research is based. It consists of background, research question, research objective, research benefit, and writing systematic.

Chapter II Literature Review

This chapter discusses about theory that is related to the research problem, results of previous research, directions for creating the hypothesis, and hypothesis development.



Chapter III Research Method

This chapter contains research design, population and samples, techniques and sources of data collection, operational definition and measurement of variables research, data analysis methods, and hypothesis test.

Chapter IV Result and Discussion

This chapter will describe the results of hypothesis testing, interpretation of the results, arguments for the results of the research, and additional analysis.

Chapter V Conclusion and Recommendation

This chapter includes the conclusions and limitations of the research results. This chapter will also contain suggestions for the future researchers to overcome the limitations of existing research.