CHAPTER I

INTRODUCTION

1.1 Background

The global community is heavily debating climate change. More than 80 percent of Generation Z who live in Indonesian cities have a high cognitive awareness of climate change issues (Ariestya, 2020). Today's Generation Z shows a high level of awareness of climate change, largely influenced by easy access to information through the internet and social media. They have grown up in the midst of an active environmental movement, with many engaging in online demonstrations and petitions urging action on climate change. Their personal experiences also played a role, as this generation witnessed first-hand the impacts of climate change through extreme events such as floods, storms and forest fires that occurred globally. Schools and colleges are also supporting this awareness by incorporating environmental issues into the curriculum. This is in line with research conducted in urban areas around the health campus of the city of Pune in India, where 91.68% of respondents over the age of 18 stated that the global climate has changed. (Pandve et al., 2011). Of the 26 countries around the world, 13 place climate change as the biggest international threat, when compared to other threats (Poushter & Huang, 2019). Moreover, according to the Asahi Foundation (2021), 25 countries around the world place climate change as the most important environmental issue. Waste transfer, emissions, destruction of toxic waste, protection of the ozone layer, and climate change are some of the natural issues, according to Gamble et al. (1996). In the 1980s, attention to the negative impact of organizations on the environment slightly faded, namely in the 1990s this topic reappeared (Kolk, 2003). Therefore, discussions related to this environmental issue need to be discussed again at this time.

The continued increase in global temperatures raises public concerns about climate change. According to the National Aeronautics and Space Administration (2022), the Earth's surface temperature by 2022 is 0.89 degrees Celsius above the average reference temperature from 1951 to 1980 (NASA, 2023). The economic and social sectors will be affected by the magnitude of the change that is taking place. Decreased quantity and quality of water, habitat changes, declining species of flora and fauna, increased greenhouse gas effects, decreased agricultural land, and declining agricultural productivity are some of the possible impacts (Santika, 2023). Therefore, to meet this challenge, there is a need for concerted efforts among countries and sectors to reduce greenhouse gas emissions, protect ecosystems, enhance adaptation, and promote socially and environmentally sustainable economic development.

The concept of sustainable finance has evolved in response to the problem of climate change. For more than twenty years, international forums have been discussing sustainability. A lot of negative criticism about environmental damage is increasing every year, which can lead to a global economic crisis, causing this problem to emerge. As a result, stakeholders hope that the company can manage the business sustainably. Companies are expected to be able to manage the impact of their business operations by being environmentally friendly, having good governance, and having social responsibility. Companies should disclose financial and non-financial information as transparently as possible to gain the trust of stakeholders. Following this line of thinking, Stakeholder theory states that a company's capacity to generate sustainable wealth is determined by its relationship with its various stakeholders.

Sustainability reports are becoming popular almost all over the world and are growing. The term Environmental, Social, and Governance (ESG) is the most commonly used. ESG disclosure is responsible for assessing the practices of the indicators it contains: environmental (E), social (S), and corporate governance. (G). The European Council defines ESG policies into account when choosing investments in the financial sector, resulting in long-term investment in sustainable economic activities and projects. (European Commission, n.d.).

Based on a study conducted by Deutsche Bank (2021) of 530 investors and issuer companies from various countries around the world, ESG environmental elements are ranked higher in Europe, while social elements are ranking lower in the United States. (Reid et al., 2021). Environmental and social factors are the main focus for investors in making their investment strategies. They argue that ESG investments have more advantages in the market than non-investment companies ESG (Reid et al., 2021). Moreover, issuer companies use ESG as one way to attract stakeholders, investors, by using it as a basis for issuer firms to communicate their corporate sustainability strategies to investors and capital markets. (Reid et al., 2021). The potential to raise money at low costs is a major factor in companies looking to the capital markets for assistance. This is dependent, though, on businesses' ability to fairly compensate investors, as they give preference to businesses that offer a higher return per unit of risk. For businesses, the accuracy, comprehensiveness, and dependability of institutional communication with the market through reports is crucial in this regard (Mendes-Da-Silva et al., 2014). As such, ESG is not only a risk assessment instrument, but also a tool to enhance a company's attractiveness in the capital market, create long-term value, and support overall sustainable development. A company's commitment to sustainability and Corporate Social Responsibility (CSR) lowers uncertainty, business risk, and consequently the cost of capital for the company (Bassen et al., 2006; Orlitzky and Benjamin, 2001). Dhaliwal et al., (2011) looked into whether the voluntary disclosure of non-financial information affected the risk of the company and its capital cost. They found that when companies with high capital costs in a given year disclosed their ESG initiatives, their cost of capital decreased.

OJK Regulation (POJK) Number 51/POJK.03/2017 on the Implementation of Sustainable Finance for Financial Services Institutions, Issuers and Public Companies. The main concern of POJK Number 51/POJK.03/2017 itself is to create a sustainable development that is able to ensure and maintain economic stability and a national economic system that prioritizes the balance between environmental, social and economic aspects. Even though there are clear rules, there are still irresponsible parties, for example of the environmental and gold-addition license received by Tambang Mas Sangihe (TMS) has shown that it causes forest destruction, disruption of bird habitats, and threats to clean water supply for communities living in the vicinity (Lumbanrau, 2021). In addition, a food and beverage company in Bekasi City, West Java, discharged hazardous waste into the river. Until the Bekasi City Environmental Control Agency

(BPLH) sent a warning letter to the company (Nugroho, 2017). It turns out that there are some laws and regulations made by the government and regulatory bodies that do not necessarily make companies, especially in Indonesia, manage well and be socially and environmentally responsible. Companies that pollute or engage in practices that adversely affect the environment and society may face penalties, fines, or even be forced to cease operations, which can result in financial losses and reputational damage. Meanwhile, a good reputation can be considered as evidence of the legitimacy that has been granted by society and other stakeholders.

Still unsolved, though, is the issue of whether businesses in contentious industries can adopt a more socially conscious stance. Sensitive industry sectors include sensitive industries like tobacco, gambling, alcohol, and adult entertainment. These industries are typically characterized by social taboos, moral debates, and political pressure (Cai et al., 2012). Based on Richardson and Welker (2001) and Lee and Faff (2009), we consider the following companies to be sensitive in this study: energy, including oil and gas; chemicals; paper and pulp; mining; and steel making.

The Environmental, Social, and Governance (ESG) journal has developed more slowly than the practice as CSR issues have been rebranded in the finance-focused literature. Wood (2010) proposes that research on CSR and Corporate Social Performance (CSP) is not useful when looking at the relationship between CSR and Corporate Financial Performance (CFP). Rahdari (2016) argues that this recommendation may be true for well-developed markets. However, for emerging economies, there are fewer studies conducted on this issue and a lower understanding of strengths and weaknesses, so examining this relationship may be of great benefit to the CSR literature.

The ESG literature is even more scarce when markets with less developed economies, often known as emerging markets, are taken into account (Orsato et al., 2015). This paper examines the correlation between the environmental, social, and governance (ESG) performance and company financial profile of companies listed in Indonesia's as emerging markets. Because of Indonesia's weak social and environmental requirements, ESG practices are anticipated to be more in demand in these situations than in developed markets (Dobers and Halme, 2009; Baughn et al., 2007). Researcher also look into the ESG performance of businesses in Indonesia that are involved in sensitive industries, in addition to this research gap.

For several reasons, this research is relevant and useful. First, Friede et al. (2015) state that our understanding of the relationship between ESG elements and financial performance is still very fragmented. Moreover, different types of research look at the possible differences between ESG and Corporate Financial Performance (CFP) across different contexts. In the emerging markets group, ESG and CFP have a stronger correlation than in developed markets. Secondly, most studies show that a decline in ESG ratings can be attributed to lower disclosure and compliance with ESG standards, which may lead to a riskier and more volatile investment environment. However, as Indonesia's economy develops faster, firms can make more investments in ESG practices, which will limit the impact of ESG-related costs in the long run (Peiro-Signes and Segarra-Ona, 2013). Third, although most studies have shown a positive correlation between ESG and CFP since the 1970s (Friede et al., 2015), not all agree that lower ESG performance does not necessarily result from sensitive industries (Statman and glunov, 2009; Hong and Kacperczyk, 2009). Hence, our study is relevant as it addresses all three issues, as well as pointing to the dearth of empirical evidence in Indonesia.

This research is a continuation of previous research conducted by Garcia et al. (2017). The difference between these two studies is that the former involves BRICS countries, while this study involves non-financial companies listed on the Indonesia Stock Exchange in 2020-2022. The aouthor chose non-financial companies as research because non-financial companies can have a significant impact on a company's ESG performance and overall success. Additionally, non-financial companies often face unique challenges and opportunities related to ESG issues, such as sustainability, social responsibility, and governance, which can impact their financial performance and long-term viability (Rossi, 2023). The author chose Indonesia as research because Indonesia itself is included in the emerging market and there are still few studies in Indonesia related to ESG and company financial profile and sensitive industries.

1.2 Problem Formulation

Based on the description above, the problem to be studied are:

1. Is there any significant association between systematic risk of non-financial company on IDX and its ESG performance and the pillars?

2. Is there any significant association between return on asset of non-financial company on IDX and its ESG performance and the pillars?
3. Is there any significant association between free cash flow of non-financial company on IDX and its ESG performance and the pillars?
4. Do companies in sensitive industry show better ESG performance and the pillar than companies in non sensitive industry?

1.3 Research Objective

The purpose of this research is to:

1. To empirically test and analyze the effect of systematic risk of a company of non-financial company on IDX to ESG performance and the pillars.
2. To empirically test and analyze the effect of return on asset of a company of non-financial company on IDX to ESG performance and the pillars.
3. To empirically test and analyze the effect of free cash flow of a company of non-financial company on IDX to ESG performance and the pillars.
4. To empirically test and analyze companies in sensitive industry show better ESG performance and the pillar than companies in non sensitive industry.

1.4 Research Benefit

The results of this research are expected to provide benefits for several parties. For academics, it is hoped that this research can add insight and literature related to the influence of sensitive industries on ESG performance of non-financial company on IDX. For environmentally sensitive industrial of non-financial company on IDX, it is hoped that this research can add insight into the influence of sensitive industries on ESG performance so that companies can decide on the urgency of ESG implementation within the company. For regulators, it is hoped that the results of this study can contribute to regulators to make policies related to ESG and corporate sustainability. For investors, the results of this study are expected to provide insight and literature for investors in making investment decisions by paying attention to the ESG performance of a company.

1.5 Writing Systematic

The writing systematic in this research consists of five chapters. The first chapter presents an introduction that discusses the background of the problem, problem formulation, research objectives, research benefits and writing systematics. Furthermore, the second chapter explains the literature review which contains the literature used as a theoretical basis, review of previous research, hypothesis development and conceptual framework. Then, the third chapter contains research methods consisting of research design, population, samples, types and sources of data, research variables along with data analysis methods. Then, the fourth chapter presents the results of the study which contains data analysis and discussion of the results of hypothesis testing. hypothesis test results. Finally, the fifth chapter contains conclusions, limitations and suggestions for future researchers. suggestions for future researchers.