Soedirman Accounting, Auditing and Public Sector Journal (SAAP)

ISSN 2962-2336

Vol. 2 No. 2 2023

ENVIRONMENTAL, SOCIAL AND GOVERNANCE PERFORMANCE AND COST OF DEBT: DOES THE BOARD OF COMMISSIONERS' CHARACTERISTICS PLAY A ROLE?

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Abstract

This study aims to obtain evidence of the influence of ESG performance on the cost of debt and the role of the independent committee in this relationship. The sample used consists of non-financial companies listed on the Indonesia Stock Exchange from 2011 to 2019. The final sample comprises 205 company-year observations. Data were processed using the Generalized Least Squares (GLS) method through STATA 16.0 software. The results of this study indicate that higher ESG performance leads to lower cost of debt. This suggests that creditors view ESG performance as an important practice to be implemented in a company. The study also documents findings that the independent committee does not play a moderating role in the relationship between ESG performance and the cost of debt.

Keywords: ESG Performance, Cost of Debt, Board Characteristic, Independent Committee

Abstrak

Penelitian ini bertujuan untuk memperoleh bukti tentang pengaruh kinerja ESG terhadap cost of debt dan peran dari komite independen pada hubungan tersebut. Sampel yang digunakan adalah perusahaan non keuangan yang terdaftar di Bursa Efek Indonesia pada tahun 2011 sampai dengan 2019. Sampel final terdiri dari 205 obeservasi perusahaan dan tahun. Data diolah dengan menggunakan metode Generalized Least Square (GLS) melalui program STATA 16.0. Hasil penelitian ini menunjukkan bahwa semakin tinggi kinerja ESG maka semakin rendah cost of debt. Hal ini menunjukkan bahwa kreditor memandang kinerja ESG sebagai suatu praktik yang penting untuk diterapkan dalam suatu perusahaan. Penelitian ini juga mendokumentasikan hasil bahwa komite independen tidak memiliki peran dalam memoderasi hubungan kinerja ESG dan cost of debt.

Kata Kunci: ***Kinerja ESG, Cost of Debt, Karakteristik Dewan, Komite Independen***

1. INTRODUCTION

Sustainability issues have become increasingly important on a global scale. These issues drive businesses to adopt new practices that prioritize not only financial aspects but also non-financial ones. Within the corporate context, stakeholders are pressing companies to pay more attention to these practices by reducing their social and environmental impacts and increasing transparency in disclosing sustainability information (Ahmed et al., 2019; Manes-Rossi et al., 2020; Raimo et al., 2021) . Therefore, to remain competitive in the market, the adoption of Environmental, Social, and Governance (ESG) practices has become a critical strategy for

maintaining a company's reputation and ensuring its long-term sustainability (Shahab et al., 2018). Companies' ESG practices are used as tools to demonstrate to the market and stakeholders that they actively fulfill ecological and social responsibilities, thereby enhancing their reputation in the eyes of consumers and investors and improving their competitive advantage (Bofinger et al., 2022; Gillan et al., 2021; Sugiyanto, E et al., 2021).

The increasing attention to ESG practices has also led to research exploring their implementation and their impact on companies. Some studies have documented that a company's involvement in ESG practices can enhance employee engagement, job satisfaction, organizational commitment, employee productivity, and retention (Ali et al., 2021; Jain et al., 2021; Onkila & Sarna, 2022). However, some literature has also documented that participation in ESG practices focusing on environmental activities, employee relations, and community welfare may result in a shift of focus to practices that do not enhance shareholder value but rather increase costs (Galant & Cadez, 2017; Lin et al., 2019). Therefore, an interesting question arises: Does ESG performance have positive economic consequences for companies?

Developments in the financial sector show that ESG integration in equity investments has reached a high level (Arora & Sharma, 2022). It has been well-documented that there are effects of ESG practices on the cost of equity (Chen et al., 2023; Garzón Jiménez & Zorio-Grima, 2021; Gonçalves et al., 2022; Gupta, 2018; Mio et al., 2023; Ng & Rezaee, 2015; Ok & Kim, 2019). However, literature focusing on the effects of ESG practices on the cost of debt is still limited, particularly in the context of developing countries. This is despite the fact that the corporate bond market in the global economy continues to expand. Data from the OECD (2020) reports significant growth in corporate bond issuance since 2008, with an annual average of USD 1.8 trillion in global corporate bond issuances, twice the annual average from 2000 to 2007. This highlights the importance of analyzing the effects of ESG practices on the cost of debt, especially in the context of developing countries. Therefore, this research aims to analyze the effects of ESG practices on the cost of debt, providing evidence from Indonesia as one of the developing countries.

This study also seeks to provide evidence regarding whether the independent audit committee plays a role in the relationship between ESG practices and the cost of debt. The consideration of the role of the independent audit committee is based on agency theory, which suggests that auditing is a crucial monitoring instrument for reducing information asymmetry, deterring opportunistic behavior, and enhancing ESG disclosure, corporate performance, and firm value (Jensen & Meckling, 1976). The significant role of the board's audit committee has been shown to have a substantial impact on strengthening the relationship between ESG disclosure and financial aspects. Oversight committees within the board, such as audit, nomination, and remuneration committees, have a positive impact on firm value (Hu et al., 2020; Muchemwa et al., 2016; Ntim, 2015; Trisnawati et al., 2022). Therefore, the role of the independent audit committee will be tested to provide deeper insights.

2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

1) The Effect of ESG Performance on Cost of Debt

The practice of ESG and its relationship with the cost of debt is grounded in stakeholder theory. Stakeholder theory explains that in order to gain support from stakeholders, companies need to implement relevant practices (Deegan, 2014), and one of the practices that is now crucial for integration is ESG. ESG practices have become essential because a company's sustainability and existence cannot be achieved if it disregards its environment. Therefore, stakeholders, including creditors, are paying increasing attention to the implementation of ESG practices. This heightened attention increases creditors' awareness of integrating ESG information into their credit evaluation processes (Eliwa et al., 2021). This is concretely manifested through the signing of the United Nations Environment Programme's Statement by banks in various countries in the Environment and Sustainable Development. Therefore, considering creditors' concerns about reputation risk and a company's sustainability, companies need to adopt sound ESG practices. In other words, companies with poor ESG performance tend to face difficulties in obtaining credit or are burdened with high debt costs, or cost of debt.

Several studies have attempted to document the relationship between ESG and the cost of debt. Ahmed et al., (2019) analyzed 15 European countries and found that companies would benefit from increasing efficiency and transparency in disclosing ESG information. Companies with higher ESG performance scores tend to have lower debt costs. In a similar vein Ben Slimane et al. (2020) and Li et al. (2022) stated that the bond default rate is negatively correlated with corporate social responsibility and governance. In the context of developing countries, Bhattacharya & Sharma (2019), using a sample of 122 BSE 500 companies in India, documented that ESG performance was found to have a significant positive credit metric. Fonseka et al. (2019) and Gracia & Siregar (2021) documented that ESG practices reduce the cost of debt.

H1: ESG Performance has a negative impact on the cost of debt

2) The Role of Independent Audit Committees on the Relationship between ESG Performance and Cost of Debt.

One aspect considered crucial in a company is the presence of an audit committee. The audit committee is a vital pillar of good corporate governance. Based on agency theory, the existence of an audit committee deters opportunistic behavior, enhances disclosure, corporate performance, and firm value (Jensen & Meckling, 1976). Agency theory explains that board committees with significant influence play a vital role in strengthening the relationship between disclosure and corporate performance. This is because these committees consist of independent and competent members who can oversee the actions of executive directors, thus

improving the financial performance of the company (Elmghaamez et al., 2023). Therefore, the presence of an independent committee will enhance efficiency and effectiveness in the practices implemented in the company, including ESG practices, thereby increasing creditors' confidence in the company and reducing the cost of debt.

Several studies aim to provide a basis for analyzing independent committees in a company's ESG practices. Buallay & Al-Ajmi (2020) documented that independent company committees have a positive influence on ESG practices in companies in Gulf countries (GCC). The same is suggested by Dwekat et al. (2020), who found that audit committees contribute to a company's ESG level. Other studies also document a positive effect between aspects of audit committees and ESG and performance (Arif et al., 2020; Bravo & Reguera-Alvarado, 2019; Garas & ElMassah, 2018; Raimo, Vitolla, et al., 2021).

H2: ***Independent audit committees positively moderate the relationship between ESG performance and cost of debt.***

3. RESEARCH METHOD

The sample used in this study consists of non-financial companies listed on the Indonesia Stock Exchange from 2011 to 2019. The sample comprises 205 company-year observations. The determination of the sample was conducted using a non-probability sampling method, namely the purposive sampling technique, as presented in the following table:

Table 1.Sample Selection

Number	Sample Criteria	Number of observations
1	Non-financial companies with ESG score-related data	252
2	Providing data for the cost of debt calculation	250
3	Providing data related to the company's independent board	243
4	Providing data for the control variables used	205

Source: Author's processed data

ESG performance data were obtained from the Thomson Reuters database. Meanwhile, the data used for the calculation of the cost of debt and data related to the independent committee were acquired through content analysis of the companies' annual reports. Cost of debt represents the average rate of the cost that a company must pay when it has a certain amount of debt to creditors (Sengupta, 1998). The cost of debt calculation is performed using the following formula (Shad et al., 2020):

Cod ***= Total interest expenses x (1-Effective tax rate)***

Meanwhile, the independent committee variable is the proportion of the total number of independent audit committees to the total number of audit committees (Elmghaamez et al., 2023). This study includes several control variables, namely leverage (LEV), return on assets (ROA), company size (SIZE), and company growth (GROWTH). The regression equation in testing these hypotheses is as follows:

$ESG_{i,t} = \alpha + \beta1COD_{i,t} + \beta2INDEP_{i,t} + \beta3COD*INDEP_{i,t} + \beta4LEV_{i,t} + \beta5ROA_{i,t} + \beta6SIZE_{i,t} + \beta7GROWTH_{i,t} + \varepsilon$

Information:

$ESG_{i,t}$	= ESG performance score of company i in year t
$COD_{i,t}$	= *Cost of debt of company i in year t*
$LEV_{i,t}$	= Liability to total asset ratio of company i in year t
$ROA_{i,t}$	= Profit to total asset ratio of company i in year t
$SIZE_i$	= Natural logarithm of total assets of company i in year t
$GROWTH_{i,t}$	=Revenue growth rate of company i in year t

4. RESULTS AND DISCUSSION

Table 2. Descriptive Statistic

Variable	Observation	Mean	Std. Dev	Min	Max
COD	205	214852.4	382211.5	-820.2115	2369977
ESG	205	43.3102	20.42217	8.22	88.28
INDEP	205	2.980488	1.256204	0	.8571429
LEV	205	.4734506	.2395261	.1264213	1.897679
ROA	205	.0796527	.0961645	-.567252	.4467578
SIZE	205	24.39349	.8494712	22.29617	26.58678
GROWTH	205	-.2159121	3.869472	-55.28969	.9853861

Source: Author Processed Data, 2023

Table 2 presents descriptive statistics for the variables, Cost of debt, ESG, independent audit committee, and several control variables, namely leverage (LEV), ROA, Company Size (SIZE), and company growth (GROWTH). The variable Cost of debt (COD) has an average value of 214,852.4, which is lower than the standard deviation value of 382,211.5. Therefore, it can be concluded that the cost of debt has a relatively even distribution of data.

The average value for the ESG variable is 43.3102, higher than the mean of 20.42217. This indicates a relatively high data distribution for ESG. The variable has a minimum value of 8.22 and a maximum value of 88.28. The average value for this variable approaches the maximum value, indicating that many samples in this study have high ESG performance.

The average value for the independent committee variable (INDEP) is 2.980488, higher than the standard deviation value of 1.256204, suggesting a relatively high data distribution for independent committees.

Table 2 also presents descriptive statistics for several control variables used in this study. The leverage variable (LEV) shows an average value of 0.4734506 with a standard deviation of 0.2395261. The minimum and maximum values for the leverage variable are 0.1264213 and 1.897679, respectively. The second control variable, ROA, has an average value of 0.0796527 and a standard deviation of 0.0961645. The minimum and maximum values for this variable are -0.567252 and 0.4467578. The SIZE variable has an average value of 24.39349 and a standard

deviation of 0.8494712. The minimum and maximum values are 22.29617 and 26.58678. The last control variable is GROWTH, which has an average value of -0.2159121 and a standard deviation of 3.869472. The minimum and maximum values for this variable are -55.28969 and 0.9853861.

Before hypothesis testing, this study determined the best model through a series of tests. The result of the Chow test, namely a P-value of 0.0000, is smaller than Alpha 0.05. Therefore, the best choice is the Fixed Effect model. Subsequently, the result of the Hausman test shows that the P-value is 0.9913, which is higher than Alpha 0.05. Thus, the best model choice used in this study is the Random Effect model.

Table 3. Regression Results of the Relationship between Cost of Debt and ESG

COD	COEF	Z	p>|z|
ESG	-4749,226	-3,70	0,000
INDEP	-90710,43	-1,00	0,316
LEV	77359,42	0,61	0,542
ROA	103587	0,32	0,747
SIZE	29679,21	0,87	0,385
GROWTH	4080,508	0,60	0,547
CONS	-322237,5	-0,39	0,700

Source: Author Processed Data, 2023

Table 3 shows the regression results on the impact of cost of debt on ESG performance, which exhibits a negative and statistically significant direction. This is indicated by the p-value of 0.000, which is lower than the significance level of 0.05, with a coefficient of -4749.226. These findings align with the first hypothesis, suggesting that higher ESG performance in a company is associated with lower cost of debt. The implementation of ESG practices is a concern for creditors because ESG practices are linked to the long-term sustainability of a company. Companies that neglect their environmental responsibilities face high risks related to reputation, legal issues, and business sustainability. This argument is reinforced by stakeholder theory, which asserts that companies implementing good ESG practices will reap long-term benefits and gain trust from stakeholders (Deegan, 2014). Therefore, companies with low ESG performance will encounter difficulties in obtaining credit, and creditors may impose higher cost of debt. These results are consistent with those documented in advanced economies (Ahmed et al., 2019; Ben Slimane et al., 2020; Li et al., 2022).

Table 4. Regression Results of the Role of the Independent Committee on Cost of Debt and ESG

COD	COEF	Z	p>|z|
ESG	-5866,003	-3,16	0,002
INDEP	- 240545,5	-1,20	0,232
ESG*INDEP	3555,691	0,83	0,404
LEV	75824,06	0,60	0,549
ROA	12968,41	0,04	0,969
SIZE	25683,93	0,75	0,456
GROWTH	4021,539	0,59	0,552
CONS	- 174301,8	-0,20	0,838

Source: Author Processed Data, 2023

Table 4 presents the results of Moderated Regression Analysis (MRA) on the influence of the independent committee on the relationship between cost of debt and ESG. The interaction between the ESG variable and the independent committee (INDEP) has a positive coefficient value of 3555.691 and a p-value of 0.404, which is greater than 0.05. Therefore, it can be stated that the independent committee does not moderate the relationship between cost of debt and ESG, or the second hypothesis in this study is rejected. Unlike findings in the context of developed countries, which state that the independent committee plays a role in ESG practices that affect the financial aspects of the company (Elmghaamez et al., 2023), the findings in this study document contrasting results. The independent committee in the context of developing countries, especially in the context of Indonesia, does not have such a role. This differs from the argument that the independent committee plays a role in advising management to generate high ESG practices (Alhossini et al., 2021). The independent committee in the context of this study has less focus on ESG aspects, unlike in developed countries where the independent committee is part of a committee specifically dedicated to monitoring and providing guidance for the implementation of good ESG practices, expected to have positive impacts on the financial aspects of the company.

5. CONCLUSION

This study documents that ESG performance has a significant negative impact on the cost of debt. Creditors pay attention to the ESG performance of companies, so companies with poor ESG performance will receive or be burdened with high costs of debt. This research also documents the result that the independent committee does not play a role in moderating the relationship between ESG performance and the cost of debt.

This study is not without limitations. This research aims to provide evidence from a developing country context using Indonesia as a sample. This makes the research less generalizable. Therefore, future research is expected to conduct cross-country analysis involving various countries categorized as developing nations. This study also only uses one aspect to measure ESG practices, namely ESG performance. Future research is expected to analyze ESG practices by considering both ESG performance and ESG disclosure.

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