THE INFLUENCE OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) DISCLOSURE ON FIRM RISK

(Empirical Study on Non-Financial Companies
Listed in Indonesia Stock Exchange)

UNDERGRADUATE THESIS

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DECLARATION OF ORIGINALITY

I am, Fitri Anita Aritonang, clarify that this thesis with the title of **THE INFLUENCE OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) DISCLOSURE ON FIRM RISK (EMPIRICAL STUDY ON NON-FINANCIAL COMPANIES LISTED IN INDONESIA STOCK EXCHANGE)**, is true as the result of my own writing. I hereby state the truth that in this thesis, there is no whole or in part written by others which I take by copying or imitating in the form of sentence sequences or symbols that show ideas or opinions or thoughts of another author, which I admit as my own writing, and/or there is no part or the whole writing which I copy from the others writing without giving the original author recognition.

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MOTTO AND DEDICATION

"Commit to the Lord whatever you do, and He will establish your plans."

(Proverbs 16:3)

"Take small steps every day and one day you will get there."

This thesis is dedicated to:

My beloved Mama and Papa, as well as my dear brothers and sisters,

Who will always be the reasons to keep the spirit and keep doing the best

ABSTRACT

This study aims to analyze the influence of Environmental, Social and Governance (ESG) disclosure on firm risk. ESG disclosure covers the environmental, social and governance issues considered by stakeholders to reflect a company's accountability. This study used the indicators of GRI-G4 indices to measure the scores of ESG disclosure. Firm risk is represented by total risk which measured by calculating the standard deviation of daily stock returns to reflect the stock volatility. Total risk categorized into systematic risk which measured by calculating the market beta and idiosyncratic risk which measured by calculating the standard deviation of residuals. The measurement of risk in this study based on the Sharpe's CAPM model.

The research object of this study was non-financial companies listed in Indonesia Stock Exchange (IDX) that issued sustainability report over the period 2014-2016. This study used purposive sampling method in determining the sample and this study obtained 36 samples of companies as well as 90 firm-year observations. The data used in this study were secondary data which collected by performing documentation study and literature study. The data then tested by using multiple linear regression as analysis method in this study.

The findings of this study showed that environmental and social disclosures were significantly negatively influenced the total risk, systematic risk, and idiosyncratic risk. However, the governance disclosure just significantly influenced the total risk and insignificantly influenced the systematic risk and idiosyncratic risk. Nevertheless, the governance disclosure has a positive influence on all of the risk measure.

Keywords: ESG disclosure, total risk, systematic risk, idiosyncratic risk

ABSTRAK

Penelitian ini bertujuan untuk menganalisis pengaruh pengungkapan Lingkungan, Sosial dan Tata Kelola (ESG) terhadap risiko perusahaan. Pengungkapan ESG mencakup isu - isu lingkungan, sosial dan tata kelola yang dipertimbangkan oleh pemangku kepentingan untuk mencerminkan akuntabilitas perusahaan. Penelitian ini menggunakan indikator indeks GRI-G4 untuk mengukur skor pengungkapan ESG. Risiko perusahaan direpresentasikan oleh risiko total yang diukur dengan menghitung standar deviasi pengembalian saham harian untuk mencerminkan volatilitas saham. Risiko total dikategorikan ke dalam risiko sistematis yang diukur dengan menghitung beta pasar dan risiko idiosinkratik yang diukur dengan menghitung standar deviasi residual. Pengukuran risiko dalam penelitian ini berdasarkan pada model CAPM Sharpe.

Objek penelitian dalam studi ini adalah perusahaan non-keuangan yang terdaftar di Bursa Efek Indonesia (BEI) yang menerbitkan laporan keberlanjutan selama periode 2014-2016. Penelitian ini menggunakan metode purposive sampling dalam menentukan sampel dan penelitian ini memperoleh 36 sampel perusahaan serta 90 perusahaan yang menjadi data observasi. Data yang digunakan dalam penelitian ini adalah data sekunder yang dikumpulkan dengan melakukan studi dokumentasi dan studi pustaka. Data tersebut selanjutnya diuji dengan menggunakan regresi linier berganda sebagai metode analisis dalam penelitian ini.

Temuan – temuan penelitian ini menunjukkan bahwa pengungkapan lingkungan dan sosial berpengaruh negatif dan signifikan terhadap risiko total, risiko sistematis, dan risiko idiosinkratik. Akan tetapi, pengungkapan tata kelola hanya secara signifikan mempengaruhi risiko total dan secara tidak signifikan mempengaruhi risiko sistematis dan risiko idiosinkratik. Namun demikian, pengungkapan tata kelola memiliki pengaruh positif pada semua ukuran risiko.

Kata kunci: Pengungkapan ESG, risiko total, risiko sistematis, risiko idiosinkratik

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CHAPTER I

INTRODUCTION

1.1 Background

The Fourth Industrial Revolution marks current global transformation. This revolution is the era of digitalization leading to technological convergence that disguises boundaries among physical, digital, and biological environments and creates a new genetic engineering and neurotechnology capability (WEF, 2016). The emergence of the Fourth Industrial Revolution caused competition among business people increasingly tight.

The competitiveness becomes one of the important factors to be considered in maintaining economic growth. The companies are increasingly competing in creating some innovations in order to maintain its business continuity in the future (WEF, 2016). Therefore, company's vision is no longer merely short-term but also long-term oriented.

As a result, if companies want to achieve their long-term vision, they need to increase their global competitiveness. However, at the same time, the level of global competitiveness of a country is actually also being decreased. The comparisons of the Global Competitiveness Index 2015–2016 and 2016–2017 showed that, for example, Indonesia's ranking decreased from 37th to 41st among 138 countries in the world (WEF, 2016). Consequently, investments are needed as a way to encourage global competitiveness enhancement; however, any action taken might create risks.

Investors and other stakeholders have always considered firm risks before having an investment in a company. Firm risk consists of accounting and market-based risks (Orlitzky and Benjamin,2001). Accounting-based risk is a risk influenced by internal accounting returns, such as ratio of total liabilities to total assets, standard deviations of return on asset (ROA) or return on equity (ROE), and coefficient of return on investment capital (ROIC) variation. Meanwhile, the market-based risk is a risk caused by the fluctuations in the financial performance of the stock prices over time, such as total risk which includes systematic risk and idiosyncratic risk.

Firm risk occurs due to high uncertainty of both economic and market conditions. Most of the global companies currently operate in uncertain and risky environments (Benlemlih et al., 2016). Volatility may increase when financial crisis and economic recession occur (Bouslah et al., 2016). As a result, the companies have uncertain cash flow and dividend in the future that could potentially pose a risk (Kim et al., 2017).

Furthermore, firm risk can adversely affect the company and its shareholders. Firm risk potentially leads to a loss of corporate value due to the uncertainty of future results or events (K. Chang et al., 2014). Therefore, firm risk might become an important determinant of the company's cost of capital affecting the shareholder values (Bouslah et al., 2016) and can increase the cost of capital (Kim et al., 2017). Consequently, the shareholder values may decrease.

Firm risk may also adversely affect stakeholders of a company. The stakeholders potentially have to bear the residual risk of the company (Benlemlih et al., 2016). Thus, employees may at times be fired when the company is in crisis or go bankrupt. Moreover, the investor may incur losses when the company is in a decline in stock prices.

Consequently, the stakeholders prefer to get involved in the companies that have a lower risk. In another word, the firm risk can obstruct the cooperation between a company and its stakeholders (Kim et al., 2017). Meanwhile, these stakeholders have a very important role in the achievement of the sustainable operational success of a company. Accordingly, the company needs to have a strategy to mitigate their risk.

Among strategies extensively and objectively chosen to mitigate the risk, environmental and social disclosures have been considered essential. Environmental and social disclosures reflect the actual and the real activity of Corporate Social Responsibility (CSR) (Benlemlih et al., 2016), as company’s business practices are also judged environmentally and socially; thereby, the company can create good relationships with its stakeholders. The good relationships can be created because the CSR related activities demonstrate the company as a good citizen (Kim et al., 2017). In addition, the good relationships can facilitate the company in carrying out the company's operations, so the operational costs or the input costs will be lower and reduce the risk (Benlemlih et al., 2016).

Yet, environmental and social disclosures are not enough to serve as the only corporate risk mitigation strategies; other policy is needed. The attention of the importance of corporate governance increases globally (Grove et al., 2011), and the identification of corporate governance mechanisms becomes one of the crucial issues for stakeholders (Kolk and Pinkse, 2010). Therefore, the governance disclosure in this study is also required as a part of risk mitigation strategies.

Governance disclosure reflects the transparency of information disclosure. The transparency can help reduce asymmetric information between companies and investors (Cormier et al., 2009). The governance disclosure can serve as an analytical tool for investors to detect the potential governance issues as early as possible, so investors can effectively measure the value of the investments and business risks (Chang et al., 2015). In addition, the governance disclosure may motivate a company to create the optimal governance mechanisms; so that, the stakeholder's confidence in the company might increase. Thus, environmental, social and governance (ESG) disclosures might effectively serve as risk mitigation strategies.

ESG disclosure as a risk mitigation strategy closely relates to sustainable development. The highly sustainable development reflects the company's excellence judged based on the disclosures of the application of environmental, social and governance standards (Eccles et al., 2014). This sustainable development is in line with Agenda 2030 entitled "Transforming Our World," which includes 17 sustainable development objectives (SDGs) for the realization of human welfare and environmental preservation (United Nations, 2016).

Indonesia as one of UN member states is also committed to the sustainable development. Therefore, companies in Indonesia are required to perform environmental and social responsibilities as set out in the law number 40, 2007. The regulation of this responsibility in Article 74 stipulated, "The Company is obliged to carry out its social and environmental responsibilities in carrying out its business activities in the field and/or associated with the natural resources. If the company does not perform its obligations, the company shall be liable to sanctions in accordance with applicable laws and regulations." The implementation of these responsibilities can be identified by environmental, social and governance (ESG) disclosures conducted by a company.

Moreover, ESG disclosure reflects the measure of a company's social performance (CSP). Highly social performance is assumed potentially increase the company's value or company's financial performance, which is reflected by the increase of the cash flow and/or the decrease of the cost of capital (Plumlee et al., 2015). Therefore, the social performance is assumed to have a relationship with firm risk because the cost of capital of a firm is determined by the firm risk (Bouslah et al., 2016). Thus, environmental, social and governance (ESG) disclosures are considered influence the firm risk.

A number of earlier empirical studies have examined the influence of ESG or CSR disclosure on firm risk. However, the results of previous studies are inconclusive. Orlitzky and Benjamin (2001), El Ghoul et al. (2011), Jo and Na (2012), Bouslah et al. (2016), Benlemlih et al. (2016), and Sassen et al. (2016) found that ESG or CSR disclosure has a negative influence on firm risk.

Meanwhile, Nguyen et al. (2015), as well as Kim et al. (2017), showed the positive influence of ESG or CSR disclosure on firm risk. In addition, Gramlich and Finster (2013) did not even find a clear evidence that sustainability through ESG disclosure can lower the risk.

The different findings among earlier empirical studies were due to the differences in ESG or CSR disclosure measure. Some researchers used an aggregate ESG or CSR disclosure measures, such as Orlitzky and Benjamin (2001), El Ghoul et al. (2011), Jo and Na (2012), Gramlich and Finster (2013), and Kim et al. (2017). Meanwhile, the other researchers used an individual ESG or CSR disclosure measures as independent variables, such as Nguyen et al. (2015), Bouslah et al. (2016), Benlemlih et al. (2016), and Sassen et al. (2016).

Another cause of the discrepancy of findings among earlier empirical studies was the difference in risk measures used in the different time ranges and sub-samples. Some researchers used the accounting-based risk measures, such as Orlitzky and Benjamin (2001), El Ghoul et al. (2011), Gramlich and Finster (2013), and Nguyen et al. (2015). Meanwhile, several other researchers used the market-based risk measures, such as Jo and Na (2012), Bouslah et al. (2016), Benlemlih et al. (2016), Sassen et al. (2016), and Kim et al. (2017).

The previous empirical studies that investigated the influence of ESG disclosure on firm risk in Indonesia were still hard to find. Most previous empirical studies in Indonesia still used CSR concepts and the companies that disclose the ESG or CSR disclosure in their reports were still limited. One of the empirical studies in Indonesia examined the influence of corporate CSR on banking performance and risk. This study found that CSR has a negative and significant influence on liquidity risk and capital risk, but CSR has no significant influence on credit risk (Deni, 2015).

The limitations of the previous empirical studies led to further research needed to examine the influence of ESG disclosure on firm risk in Indonesia. This study was a replication of the previous studies by Benlemlih et al. (2016) and Sassen et al. (2016). The dependent variable was similar to those used by Benlemlih et al. (2016). Meanwhile, the independent variables used in this study were similar to those used by Sassen et al. (2016).

The dependent variable used in this study was the firm risk. The firm risk in this study was represented by the total risk. The total risk reflected the volatility of a company's total stock or its variation in returns from time to time. Furthermore, this total risk was divided into systematic risk and idiosyncratic risk. The systematic risk indicated a risk that depended on the external market factors or the company's ability to respond the changes in market indices that affect the overall stock returns due to economic conditions and inflation. Meanwhile, the idiosyncratic risk indicated the residual risk that was influenced by the company-specific characteristics, such as strategy decisions and output of the company, i.e. the products and services quality.

The independent variable used in this study was ESG disclosure. ESG disclosure could be quantified by calculating each disclosure score that can be seen in multiple sources. The sources of disclosure consist of an annual report, a company website, and a sustainability report (Benlemlih et al., 2016). However, this study calculated the disclosure scores based solely on ESG disclosure found in the sustainability reports published by the company each year. The disclosure score was measured based on the data points with reference to the index of the Global Reporting Initiative (GRI).

The measurement of ESG disclosure scores in this study referred to the latest GRI index, i.e. the GRI-G4 index. The GRI-G4 index has been published since 2013, but all companies effectively have used it since 2014. The GRI-G4 index is accessible through the www.globalreporting.org website.

In this study, a number of control variables were used to control the influence of ESG disclosure on firm risk. These variables were financial ratios, which serve as the fundamental factors. The financial ratios consist of the profitability ratio, the liquidity ratio (Sassen et al., 2016), and the leverage ratio (Benlemlih et al., 2016). The profitability ratio was used to measure a company's ability to generate profits. Furthermore, the liquidity ratio was used to measure the company's ability to meet its short-term financial obligations. Meanwhile, the leverage ratio was used to measure the company's ability to meet its long-term liabilities.

This study focused on analyzing the influence of environmental, social and governance (ESG) disclosure on firm risk to non-financial companies listed in Indonesia Stock Exchange (IDX). The companies sampled in this study also issued the sustainability reports over the period of 2014-2016.

1.2 Problem Formulation

The background of problems described has shown that environmental, social and governance (ESG) disclosure could serve as a risk mitigation strategy. Therefore, environmental, social and governance (ESG) disclosure could affect firm risk. However, several earlier empirical studies showed that the influence of environmental, social and governance (ESG) disclosure on firm risk was still inconclusive and promoted different results. The difference in the outcomes among former empirical studies was taken as the major problem in this study.

Meanwhile, prior empirical studies in Indonesia that examined the influence of the environmental, social and governance (ESG) disclosure on firm risk were also limited. Some previous empirical studies had largely focused on the companies in America and Europe. Therefore, the focus of the examination was to analyze the influence of environmental, social and governance (ESG) disclosure on firm risk of existing companies in Indonesia.

Based on the previous elaboration, the following research questions are proposed:

1. Does the Environmental disclosure negatively influence the firm risk?
2. Does the Social disclosure negatively influence the firm risk?
3. Does the Governance disclosure negatively influence the firm risk?

1.3 Study Objectives and Benefits

1.3.1 Study Objectives

The outline objective of this study is to analyze the influence of environmental, social and governance (ESG) disclosure on firm risk using the indicators contained in the Sustainability Reporting Guidelines index (GRI-G4). The objectives of this study were to be able:

1. to analyze the influence of environmental disclosure to the firm risk.
2. to analyze the influence of social disclosure to the firm risk.
3. to analyze the influence of governance disclosure to the firm risk.

1.3.2 Study Benefits

These results of the study are expected to provide some benefits, which are as follows:

1. **Theoretical Benefits**

   Theoretically, the result of this study is expected to be a reference addition to the development of accounting sciences, especially for the environmental social accounting and behavioral accounting related to environmental, social and governance disclosure in managing firm risk. In addition, the results of this study are also expected to be a reference for the subsequent similar studies.

2. Practical Benefits

Practically, the results of this study are expected to be an input for companies to pay more attention to disclose ESG disclosure in the integrated annual reports or the sustainability reports. Furthermore, the results of this study are expected to be used as additional information for investors in making investment decisions that take into account the influence of environmental, social and governance factors on firm risk. In addition, the results of this study are also expected to serve as input for the government in drafting further regulations related to environmental, social and governance disclosures.

1.4 Systematics Writing of Study

CHAPTER I: INTRODUCTION

This chapter contains the background explanations of the problem, the formulations of the problem, the purposes and the usefulness of the research, and the systematics of writing.

CHAPTER II: LITERATURE REVIEW

This chapter contains the literature review that covers the theoretical basis and discussion of previous similar study results. In addition, the framework and the hypotheses are also presented in this chapter.

CHAPTER III: RESEARCH METHODS

This chapter contains an explanation of research variables and operational definition of variables, the determination of population and sample of this study, the type and the sources of data, the methods of data collection as well as data analysis.

CHAPTER IV: RESULT AND DISCUSSIONS

This chapter contains an explanation of the object descriptions of the study, data analysis, and the interpretation of this study results.

CHAPTER V: CONCLUSIONS

This chapter contains the conclusions of this study as well as the limited research and suggestions on the study that has been done for subsequent research.