

CHAPTER I

INTRODUCTION

1.1. Background of the Study

In recent years, the intersection of sustainability and corporate finance has become one of the most discussed areas in academic research and financial markets. Environmental, Social, and Governance (ESG) factors are now widely recognized as critical components of corporate strategy, reflecting how firms manage their environmental responsibilities, social relationships, and governance practices. ESG performance not only influences a firm's reputation and stakeholder trust but can also have tangible financial implications, particularly in how investors and creditors evaluate risk and determine required returns (Handajani et al., 2026). The evolution of ESG investing worldwide has placed pressure on companies, including those in emerging market, to demonstrate accountability and transparency through structured ESG disclosures. These developments create a strong foundation for examining whether ESG performance influences a firm's cost of capital measured by weighted average cost of capital, a key indicator of financing efficiency.

In the Indonesian context, the importance of ESG performance has been reinforced by regulatory and institutional changes. The Indonesia Financial Services Authority (OJK) and the Indonesia Stock Exchange (IDX) have introduced sustainability reporting requirements for listed companies, promoting standardized ESG performance frameworks. This ruled in OJK Regulation No. 51/PJOK.03/2017 on the Implementation of Sustainable Finance, which mandates

progressive sustainability reporting for IDX listed companies effective from 2021 for large scale issuers and April 2023 from medium scale issuers.

This transition reflects a broader global movement toward integrating sustainability into corporate governance and investment decision-making. Yet, the impact of these sustainability initiatives on firm-level financial outcomes in Indonesia remains underexplored. Many Indonesian firms are still in the early stages of implementing ESG policies, and the maturity of assurance mechanisms for ESG data is limited compared with developed markets. These institutional differences present an opportunity to analyze how the market values ESG information in Indonesia's evolving capital environment.

Another critical element influencing how ESG affects financing costs is audit quality. Investors often rely on audited information to reduce information asymmetry and ensure that disclosures accurately represent underlying firm performance. In theory, ESG activities should lower perceived firm risk, thereby reducing the cost of debt and equity. However, this expected benefit may not materialize if investors doubt the reliability of ESG disclosures. High audit quality, particularly when the auditor is a reputable Big 4 affiliate, enhances credibility and signals that a firm's reporting practices are reliable. As a result, audit quality may amplify the beneficial impact of ESG on a firm's cost of capital.

The literature suggests that firms with stronger ESG performance experience reduced financing costs due to improved stakeholder confidence, better operational efficiency, and lower exposure to regulatory or reputational risks. Yet,

evidence remains mixed across countries. Some studies show a negative relationship between ESG and cost of capital, while others find insignificant or even positive associations. This variation often stems from differences in measurement, institutional context, and the credibility of ESG information. The moderating role of audit quality thus becomes essential for understanding when and how ESG truly affects financing conditions.

Indonesia represents an ideal context for testing these relationships. The country's growing capital market, increasing ESG performance adoption, and diversity in audit quality across firms create natural variation suitable for empirical investigation. Moreover, the findings could inform local regulators and policymakers on whether improved assurance mechanisms and audit quality standards could enhance market efficiency in pricing sustainability information. By focusing on non-financial firms listed on the IDX and excluding those without ESG disclosures or from the financial sector, this study ensures comparability and relevance across firms.

1.2. Research Questions

Despite the increasing attention to ESG reporting in Indonesia, empirical evidence remains scarce on whether these sustainability practices translate into measurable financial advantages. Specifically, it is unclear whether ESG performance directly reduces WACC and whether this relationship depends on the quality of external audit assurance. Addressing this gap is crucial because it helps

firms and investors understand whether investing in ESG and audit quality yields concrete financing benefits.

1. Does ESG performance significantly influence the Cost of Capital among non-financial firms listed on the Indonesia Stock Exchange?
2. Does audit quality moderate the relationship between ESG performance and the Cost of Capital among non-financial firms listed on the Indonesia Stock Exchange?

1.3. Research Objectives

1. To examine the relationship between ESG performance and the Cost of Capital among Indonesian non-financial listed firms.
2. To examine whether audit quality moderates the ESG and Cost of Capital relationship, among non-financial firms listed on the Indonesia Stock Exchange.

1.4. Significance of the Study

The study provides several contributions. Academically, it extends the growing literature on ESG finance interactions by incorporating audit quality as a moderating factor in an emerging market. Practically, it informs managers that credible ESG performance supported by strong audit assurance can improve access to cheaper financing. For policymakers, the results can guide future regulations promoting audit-based verification of sustainability reports to enhance capital market transparency.