
Balancing Profit and Planet: How ESG Criteria Are Reshaping Capital Structure in Indonesia

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ABSTRACT

Environmental, Social, and Governance (ESG) criteria have gained significant importance in Indonesia's corporate landscape, driven by global trends and local initiatives. The Indonesian government's commitment to achieving the Sustainable Development Goals (SDGs) by 2030 has accelerated the integration of ESG principles into business practices. This research aims to determine the influence of ESG performance on the capital structure of companies in Indonesia. This research uses quantitative methods, analysing the relationship between ESG scores and company funding decisions, especially those using debt versus internal funding sources. The findings suggest that companies with higher ESG performance tend to rely less on debt financing and prefer retained earnings and equity to support sustainable initiatives. Companies with strong ESG practices exhibit lower environmental risks, healthier financial reports and better credit ratings, reducing funding costs. The study concludes that integrating ESG factors into corporate financing will reduce the risks associated with high debt levels and be in line with long-term value creation, improve corporate governance, and attract ESG-focused investments. This research contributes to the growing understanding of the impact of ESG on capital structure decisions in Indonesia by highlighting its role in creating a sustainable and resilient business environment.

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INTRODUCTION

Environmental, Social, and Governance (ESG) criteria are becoming increasingly important in Indonesia's corporate landscape. ESG principles evaluate companies based on environmental impact, social responsibility and governance practices (esg.idx.co.id, 2024). In Indonesia, applying ESG criteria is driven by global trends and local initiatives (PwC, 2021). The government of Indonesia has pledged to fulfil the United Nations

Sustainable Development Goals (SDGs) by the year 2030, which will further enhance the incorporation of Environmental, Social, and Governance (ESG) principles within business operations (indonesia.un.org, 2024). According to a report published by PwC, international investors exert influence on Indonesian firms to embrace ESG standards, resulting in a notable rise in ESG-related investments within the region.

ESG considerations are, in fact, intricately intertwined with today's corporate finance, affecting how firms build up their capital. The concept of ESG, therefore, will represent all those nonfinancial parameters that gauge the impact and sustainability of a firm over three dimensions: environmental, social, and governance. ESG investing screens corporations on their environmental impact, social practices, and manner of internal management along with conventional financial parameters. The ESG issues cover climate change, resource depletion, and pollution under the environmental head, emphasizing the impact of a company's operations on the natural environment. Social factors relate to a company's interaction and interrelationship with its stakeholders-employees, customers, local communities, and greater society as a whole-through labor practices, diversity, human rights, and community involvement. Governance factors include the structure and conduct of corporate boards, executive compensation, shareholder rights, transparency to ensure ethical decision-making, accountability, and long-term value creation (Saleh et al., 2024; Tsang et al., 2023). It's a holistic approach to revealing financially sound, sustainable, and ethically responsible businesses. There is a tradeoff between ESG risk and investment cost. The sustainable initiative involves a high initial investment and generates continuous cash inflows. However, the unsustainable initiative involves a lower initial investment and provides cash inflows only up to an uncertain end, making it risky due to its ESG exposure (Nishihara, 2023). The integration of ESG factors into capital structure decisions is driven by the recognition that sustainable business practices can lead to long-term value creation and risk mitigation (Asimakopoulos et al., 2023; He et al., 2024). Companies with strong ESG performance are often seen as lower-risk investments, which can affect their cost of capital. Investors and stakeholders increasingly demand transparency and accountability from companies, pushing for better ESG performance.

Hence, research into this phenomenon is warranted. In this regard, the ways that ESG principles continue to influence Indonesia's corporate environment are thus not better dramatized. By deconstructing the ways that ESG criterion has influenced corporate capital structures, any advantages and challenges related to business sustainability will be realized by researchers. This study contributes to policy guidance, improved governance of corporations, and increased ESG-themed investments. This will also enable companies to make more informed choices about the trade-offs between ESG risks and investment costs, thereby creating long-term value and reducing risks. This insight is critical to positive change and would help cultivate a more sustainable and resilient business environment in Indonesia.

LITERATURE REVIEW

Pecking Order Theory

The pecking order theory postulated by Stewart C. Myers and Nicolas Majluf (1984) states that organizations arrange sources of financing in order of least resistance and cost criteria. From this theoretical perspective, businesses would first prefer internal resources, usually retained earnings, to finance a business because this method reduces the cost and

complexities associated with external sources of finance. When internal funds are insufficient, firms would then use debt financing, as it was usually cheaper compared to equity due to advantages in tax and less risk for holders of debt. Equity financing is the least preferred since this generally entails higher costs and may send a signal to the market that the shares of the company are overvalued, hence depressing the share price.

This theoretical framework revolves around asymmetric information, whereby managers are better informed about current value and future perspective than the case of external investors. Thus, due to the problem of adverse selection and signaling problems, firms avoid external financing. Pecking order theory provides a conceptual framework through which financing choices made by a firm can be understood. Emphasis is placed on how different capital sources involve trade-offs.

Trade-Off Theory

This trade-off theory of capital structure, developed by economists Franco Modigliani and Merton Miller in their seminal 1958 work, "The Cost of Capital, Corporation Finance, and the Theory of Investment," holds that a firm should balance the respective costs and benefits of debt and equity financing in pursuit of an optimal mix. Initially, this theoretical framework suggests that companies use debt because of the tax advantages of interest payments, which consequently reduce the company's taxable income and, therefore, also reduce its taxes. However, when a company increases its debt, the possibility of facing financial difficulties and bankruptcy also increases and incurs additional costs such as legal fees, loss of reputation as well as disruption in business (Kraus & Litzenberger, 1973). Over the years, this theory has been refined to include factors such as bankruptcy costs and taxation. According to this view, the optimal capital structure is a trade-off between the tax advantages of debt and the costs of financial distress. Trade-off theory predicts that firm value will reach a maximum at the point where the marginal benefit from additional debt is offset by the marginal cost of potential financial distress.

This state of balance ensures that the organization benefits from the minimum achievable weighted average cost of capital (WACC) while maintaining financial stability. The theoretical framework emphasizes the need to achieve a balance between debt and equity to maximize firm value and reduce the risks associated with excessive leverage. This comprehensive perspective on capital structure highlights the complex factors that firms must consider to ensure continued growth and financial well-being (Modigliani & Miller, 1958; Kraus & Litzenberger, 1973).

The Effect of ESG Performance and Capital Structure

ESG performance notably impacts both financial risk and corporate capital structure. ESG performance notably impacts both financial risk and corporate capital structure. Companies actively adjust their capital structures towards an optimal configuration to maximise value and gain a competitive edge. ESG disclosure helps to minimise maturity mismatches, primarily due to improved environmental performance and governance capacity. This effect varies significantly depending on ownership structures, innovation capabilities, and access to financing (Zhao & Zhang, 2024).

Some literature also underlined the fact that ESG has played a very important role in shaping overall financing structure. Zahid et al. (2023) reported that those firms having better performance regarding ESG performance have less debt financing and easy access to equity capital from stock markets. A company that prioritizes its employees and

reputation will most likely operate at a high equity level compared to a high leverage level. Firms increasingly consider social, governance, and environmental factors in their investment decisions. This drive towards ESG disclosures influences their equity capital financing strategies. Studies show that companies involved in socially responsible investments are more likely to depend on stock equity and keep their leverage levels lower (Pijourlet, 2013). On the other hand, Zhao & Zhang (2024) have reported that all ESG indicators are positively related to the debt-to-equity ratio, indicating sustainability's role in the capital structure decision.

H1: ESG performance has a significant effect on capital structure

RESEARCH METHODS

This study employs a quantitative research method and purposive sampling to select companies listed in IDX from 2007 to 2023, using data drawn from the Bloomberg database. A total sample of 356 firm-years was gathered in this research. The analytical procedure consists of multiple linear regressions to investigate the relationships among the variables involved. The independent variable applied is the ESG score extracted from the Bloomberg dataset. By contrast, the dependent variable is the capital structure that is measured by the debt-to-total-asset ratio, which is defined as the quotient of total debt and total assets.

Among the control variables are the cash ratio, firm size, and price-to-book value. The control variables are the added factors that could influence capital structure and therefore increase the strength of the regression analysis. This kind of methodological approach will allow a wide-ranging investigation of the nexus between ESG performance and the choice of capital structure by Indonesian companies during the period under study. This extension of data from the Bloomberg database will add reliability and credibility to the results.

RESULTS AND DISCUSSION

Descriptive Statistics

Table 1. Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
ESG	356	0.62	5.97	2.4250	1.11238
DAR	356	0.00	79.97	21.0530	17.59994
PBV	356	0.06	82.44	4.3917	8.81583
CASH	356	0.76	92.80	13.0705	9.90029
SIZE	356	5.18	21.41	15.7983	4.03795

The dataset of 356 company annual observations provides in-depth metrics on a wide range of financial and ESG characteristics. The average score is 2.4250, with a standard deviation of 1.11238, indicating that ESG performance is moderate across companies. The Debt to Total Assets Ratio, or DAR, shows enormous variability, a mean of 21.0530 and a wide range of 0.00 to 79.97, indicating highly heterogeneous debt leverage practices. The average Price-to-Book Value, or PBV, is at 4.3917, indicating quite variable market valuations. Cash Ratio shows a liquidity variation of 13.0705. Firm size varies greatly, with a mean of 15.7983, reflecting heterogeneity in the data set.

Results

Table 2. Analysis Results

Independent Variables	Coefficient	Sig.
Constant	50.858	0.000
ESG	-1.464	0.064
PBV	-0.247	0.013
CASH	-0.669	0.000
SIZE	-1.040	0.000

The regression results are presented in Table 2. The results show that the significance value of ESG is 0.064, which means it is significant at 0.10 level, indicating H0 is rejected and H1 is accepted. The coefficients represent the estimated change in debt financing linked to a one-unit variation in each independent variable. Based on the analysis result, a coefficient of -1.464 for the ESG indicates that, on average, debt financing falls by 1.464 units for every one-unit increase in the ESG while keeping other variables constant. Negative coefficients imply a negative relationship with capital structure.

Discussion

The first hypothesis test declares that ESG performance significantly affects capital structure. The significant negative relationship between ESG performance and capital structure indicates that companies with higher environmental performance scores are less likely to rely on debt to fund their operations and investments. This is supported by the fact that companies with higher ESG ratings tend to have lower environmental risk and liability, a factor that again retranslates into lower financing costs and reduced reliance on debt financing. Besides, companies with sustainable ethics or goals may also favor the usage of internal financing mechanisms through retained earnings and equity financing in order to avoid financing environmentally non-friendly projects through external debt.

For instance, studies by Fuadah et al. (2023) showed that companies with high ESG performance tended to have more stable financial performances. Firms showing excellent ESG performances are bound to show better financial statements; hence, they are more prone to using less leverage in financing their activities. This can be seen in the ways they efficiently handle risks, enhance their operational efficiencies, and attract more investors. This cautious leveraging can reduce financial risks related to high levels of debt, such as interest burdens and the potential for bankruptcy. Furthermore, strong ESG practices may also improve an organization's credit rating, so that when debt is required, it will be less expensive. Still, these companies often focus on sustainable investments and internal financing to maintain their commitment to environmental, social, and governance standards. This practice allows the companies to ensure long-term financial sustainability and aligns with the ethical benchmark that investors are increasingly seeking. This is supported by Zahid et al. (2023), Adeneye et al. (2024), and Khan (2024), who evidence that those companies with better ESG performance tend to keep their debt level low.

CONCLUSION

The results of this research confirm that a company's capital structure is significantly influenced by its ESG performance. More specifically, there is a negative correlation between debt and ESG performance, meaning that companies with higher ESG scores are

less likely to rely on debt financing. Strong ESG practices have lower environmental risks and liabilities, thereby reducing funding costs. Retained earnings and equity are two internal funding sources frequently used by companies with strong ESG performance, and both also favor sustainable investments over debt.

The main focus of this study is on the relationship between capital structure and ESG performance of companies in Indonesia, which may limit the applicability of these findings to other industries or regions. Future research could broaden its focus by examining the impact of ESG across industries and regions. A more complex understanding can be gained by digging deeper into specific environmental, social and governance aspects that influence capital structure choices. The dynamic character of ESG laws and market dynamics should also be taken into account by researchers, as these factors may impact long-term patterns in corporate financial strategies.

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