CHAPTER II

LITERATURE REVIEW

AND

HYPOTHESIS DEVELOPMENT

2.1 Stakeholder Theory

Stakeholder Theory by Freeman (1984) used widely to define stakeholder theory. He defined it as any group or individual who can affect, or is affected by, firm's operations and activities. The stakeholder theory is dominant in the sustainability literature as sustainability activity go beyond profit-oriented activities, which could affect more groups of stakeholders including the general public. Organizations need to have mindset that stakeholder is a group and every purpose of the organizations goals should aim to manage their interests, needs and viewpoints as stated by Friedman (2006).

Managers of a firm need to fulfill their duty as stakeholder management. They should be the one who hand managing the corporation for the benefit of its stakeholder so that they could ensure their rights and also stakeholder's participation in managerial decision making. Other than that, the management also must act as the representative of the stockholder to ensure the survival of the firm, safeguarding the long term security of each group.

Stakeholder definition, the purpose and character of the organization and its role is vague and debatable in any kinds of literature, it has changed many times

over the years. Stakeholder definition changed by Freeman himself on 2004 as those groups who are vital to the survival and success of the corporation. Latest publications by Freeman (2006), he adds a new principle, which shows a new direction in stakeholder theory. He take perspective from stakeholder themselves and their activity into consideration in making this new principle. In his opinion, it also needs to be taken into the company's management. He states "The principle of stakeholder recourse. Stakeholders may bring and action against the directors for failure to perform the required duty of care".

2.2 Legitimacy Theory

The theory is based on the social contract that exists between a firm and the society (Deegan, 2002). Actually this theory is derived from the concept of organizational legitimacy which is defined by Dowling and Pfeffer (1975). They stated that it is a condition or status which exist when an entity's value system is in line with the value system of the larger social system which the entity is part of. When there is whether actual or potential disparity exist between the two value systems, then there is a threat to the entity's legitimacy.

Firm exists with the society's approval. A company legitimize its existence within its society if its operations and activities are seen to follow the norms which are approved by the society. In similar cases with sustainability report, example like PT. Telkom and their image which affected by CSR that is examined by Oktaviana (2012). If a firm is seen as not following the societal

the firm's operations and the expectations of the society. In terms of the sustainability report, a firm could legitimize their operations by having good sustainability practices.

With that being said, legitimacy theory relies on the idea that there is some kind of contract between a company and the society in which it operates (Deegan 2000). This contract act as a representation of many expectations that exist within society at how a company should done their business. This contract is hard to be defined since it is not permanent and vary in shapes. But, this is what is needed so that a company could operates their business and survives. Hence, the importance of released social disclosure, like sustainability report or CSR are needed so that business could show and validate their action and society can monitor organization's movement

2.3 Sustainability Report

Sustainability reporting is created by using standard from Global Reporting Initiative (GRI). Information about any contribution to the sustainability of a company is provided using the GRI standards. Sustainability report is the key platform for communicating sustainability performance and impacts – whether positive or negative (Global Reporting Index). This report also can act as an integrated reporting, means that it has more recent development that combines analysis both of financial and non-financial performance of a company.

This report is synonymous with other non-financial report. Example like Corporate Social Responsibility (CSR), triple bottom line reporting, and more. Advantage on using this report is that it is more of an integrated reporting, result of recent development that combines the analysis of both financial and non-financial performance. Even more with the new standards which is more focused and clear on each object inside the reports itself, this is much easier to understand.

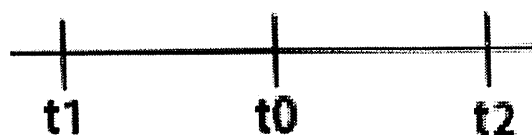
For long time, sustainability report follows GRI – G4 standards, then it is changed as of 30th June 2018 to a new GRI standards which developed by the Global Sustainability Standards Board (GSSB). This new standards already effective as a follow up of the reporting system changes on 1st March 2018. Different between the new standards and G4 are located on the formatting, it is modular now which mean fully customisable to match firm's sector. For the content, most of it stays the same since the new standards is just revised format.

Clarification is the main point in the new standards, it help organizations communicate about the impact they have on the economy, environment and society sectors. It could show the full picture of organization significant outward impacts rather than only immediate consequences from a business perspective like financial costs or damaged reputation. There are no changed principles too, it still reflect the 3 organization's impact and substantively influence the assessments and decisions of stakeholders.

2.4 Abnormal Return

Abnormal return is a term used to describe the returns generated by a given security or portfolio over a period of time that is different from the expected rate of return. It is important in determining a security's or portfolio' risk-adjusted performance when compared to the overall market or a benchmark index. An abnormal return can be either a good or bad thing, as it is merely a summary of how the actual returns differ from the predicted return. The simple equation is actual return minus with expected return, if it's positive, then the amount of return that we actually get is more than what we expect.

Actually, it is necessary to determine several period terms as the basic estimation of the expected return. It is called estimation period, which is period before the event (Disclosure of Sustainability Report) happens.



From picture above, t0 is when the event happen or event period, while t1-t2 is window period (depends on the event). For estimation period, there is no actual benchmark that is available to determine the length of the estimation period (Jogiyanto, 2010). If investors could estimate the economic value earlier, it means they could react faster (window time is shorter). But, if the economic value is hard to be concluded by the investors, they will need long time to react.

Generally the window period also involves the day before the event day to know whether there is leak of information or insider trading.

The expected return can be calculated using three estimation model (Jogiyanto, 2010) without adjusted risk, namely:

a. Mean Adjusted Return

   Stock return random near the actual price, and the market is efficient.

b. Market Model Return

   Could be done both by establish the expected model by using realization data during the estimation period, and using the expected model to estimate expected return in the window period.

c. Market Adjusted Return Model

   The researcher will use this model. This model conclude that the best assumption to estimate the stock return is from the market index return on that exact time (event time). By using this model, there is no need to create an estimation of time model, all that need to be done is to determine the observation time for each year, since estimated expected stock return are equals to the market index return.

To calculate this, Capital Asset Pricing Model (CAPM) is used. The formula is:

$$E(R_i) = R_f + \beta_i(E(R_m) - R_f)$$

Where:

$E(R_i)$: Expected return on the capital asset

R_f : Risk-free rate of interest

R_m : Market returns, use IHSG

β : Beta of stock

Certain event could lead to changes in abnormal return too, which is the main reason why there is abnormal return which later lead to market reaction. Some research suggest that the abnormal return to an event is still sensitive, but there are also one that considered it as normal. Dichev and Piotroski (2002) shows that there is no sudden increase of abnormal return for upgrades, but almost no negative abnormal returns too after the announcement of the downgrade due to under reaction to that. Continuing from that, Alwi (2003) tried to analyse Indonesian capital market reaction in accordance to bomb incident in Bali. Actually, the research shows that there are no significant difference in abnormal return between before and after the event. Setyawan (2006) also study this using the sudden increase in gasoline price, but the same result also shown.

From those research in Indonesia, it could be concluded that the factors affecting abnormal return is still vague. Big event doesn't even budge the abnormal return rate to an extreme condition. All that is left is that information released from the company which investors already invested in, since it can be considered as a direct impact. Share prices, and both internal and external factors also could take up on the role too.

2.5 Basic Theories and Previous Study

The Effect of Sustainability Report Disclosure on Abnormal Return in Indonesia

Sustainability report disclosure is an opportunity for a firm to provide a valuable information to the stakeholder which act as an investor here. It is released alongside with annual report of a company as a way to show how they treat the environment and social aspects around them. Like mentioned before, many research already done to find the use of this kind of report. Caesaria and Basuki (2017, which found performance and market improvement, Sofyani, Kurniawan and Rahmawati (2018) that look into how sustainability report could give impact to firm value, and many more.

Investor right now need sustainability related information from company. The better the information provided, near zero abnormal return is expected, since abnormal return affected by any news or information released about companies or event. Then, sustainability report that act as one of the information released may has a role in it.

Another interesting point of view regarding information released by companies to the market is that connection between abnormal return and sustainability report also could be deducted by taking market efficiency into consideration. High quality and more detailed information, also exact content that is relevance to current issues means that it could represent one characteristics of market efficiency. The more efficient a market is, the faster decision and activity done by investors.

2.6 Research Hypothesis

Based on legitimacy theory, because company seeks attention from the investors, therefore they should provide an information about good performance and profit, or in this case, sustainability. Research done by Whetman (2017) also shows that sustainability report also gave impact to company's profit, since they need money to run their sustainability related program, but disclosure itself could represent the money that has been spent on those program. Not just that, relevance level on company's financial statement could be seen from disclosure of sustainability report according to research done by Sutopo, Kot, Adiati, and Ardila (2018).

Stakeholder theory also act as one of the factors that makes company motivated to create sustainability report. They need to publish those information for their stakeholder, the main group that affect their organization the most.

News regarding how an investor care so much about disclosure of non-financial information should be an enough reason for a company to act.

Disclosed items of sustainability report is also very important, not only for public but also for investor in making their decisions. The better the quality, the more detailed, clear and understandable an information is. Finally, detailed and standardized information would affect the abnormal return since that is published to the investors. Considering this, the hypothesis is developed as follows:

H1: Sustainability report disclosure of a company significant and positively impact abnormal return.