CHAPTER II

THEORETICAL BACKGROUND, PREVIOUS RESEARCH, AND HYPOTHESIS DEVELOPMENT

2.1. Financial Reporting

Financial report is a structural presentation of a financial position and performance of an entity. The purpose is to give information of a certain financial position and performance which will benefit most financial report users. Those financial report users are existing and potential investors, lenders, and other creditors. The users' decision making depends on the return they expect from an investment in those instruments.

Existing investors use the financial report as an evaluation of its activity to increase future efficiency or whether to add or lessen their shares; while potential investors need the information to know the company's prospect, whether to buy or not to buy the shares and whether the company will give or not give dividends. For lenders and creditors, the information within financial report can give them assurance about the ability of the company to pay its debt on time. They also can decide the amount of debt they can give or the interest to be charge.

There are so many users of financial report so it can't show the exact information needed by each user. The users of financial report are divided into two which are primary and non-primary users. The primary users are the investors, creditors, and lenders; the financial report is mostly made to give information to those users. While the non-primary users have to rely on the general purpose financial report for the financial information they need since the company report its financial information based on what primary users need. Indonesian Accountant Association (IAI[1]) issued Indonesian Financial Accounting Standard (IFAS[2]) which take a role as a standard of what information should be presented in financial report in order to give basic information of the company. IFAS 1 which discuss about Presentation of Financial Statements requires company to present following information in financial statement:

1. Assets
2. Liability
3. Equity
4. Revenues and expenses including profit and loss
5. Contribution from and distribution to owner at owner's capacity
6. Cash flow

There are six components should be made in order to make complete financial statements. The components are:

1. The statements of financial position at the end of period
2. Comprehensive statement of profit and loss during the period
3. Statement of changes in equity during the period
4. Cash flows statements during the period
5. Note to financial statements consist of the summary of important accounting policies and explanatory information

[1] IAI is Ikatan Akuntan Indonesia
[2] IFAS in Indonesia term is PSAK which stands for *Pernyataan Standar Akuntansi*

6. The statements of financial position at the beginning of comparative period (presented when company is implementing retrospective accounting policies or representing financial statement items, or reclassifying financial statements items)

Chapter 1 of SFAC 8 about Conceptual Framework for Financial Reporting mentioned that general purpose financial reports which are not designed to show the value of reporting entity, but to provide information to help existing and potential investors, lenders, and other creditors to estimate the value of the reporting entity. According to IFAS 1, company can also disclose an environment statement and value added statement separately with financial statement; especially for companies which environment factor play as an important role and also for companies which consider the stakeholders as important users of the report. Further, the disclosure of these other information will give the users broader view of certain companies and help them in estimating the value.

2.2. Disclosure

2.2.1. Definition of Disclosure

Disclosure means presenting useful information to those who need it. The information disclosed should be complete, clear, and able to represent the exact economic condition. As cited by Suwardjono (2008) in Evans (2003) defines disclosure as follows:

> "Disclosure means supplying information in the financial statement themselves, the notes to the statements, and the supplementary associated with the disclosure statements. It does not extend to public or private statements made by management or information provided outside the financial statements."

Evans limits the definition on the extent of financial reporting. Wolk et al. include the segmental financial statement and price change statement as a part of the disclosure. The definition of disclosure proposed by Wolk et al. (2001) is as follows:

> "Disclosure is concerned with information in both the financial statements and supplementary communications including footnote, post-statement events, management's discussion and analysis of operations for the forthcoming year, financial and operating forecasts, and additional financial statements covering segmental disclosure and extensions beyond historical cost."

The disclosures are mainly aimed for investors and creditors. The standard amount of information should be disclosed may different according to one party to another. Securities and Exchange Commission (SEC) for instance requires companies to disclose a greater amount of information rather than Financial Accounting Standard Board (FASB). According to SEC, the qualitative and the quantitative information should also be disclosed since the financial reporting has a social aspect and public interest. While in the other hand FASB emphasizes the financial reporting on quantitative information.

Disclosure is a company's way to present all relevant information to users in order to make them able to estimate the value of the company. The relevant information is not limited on financial-related information, but also non-financial information such as inventory turnover, on time delivery, elapse time between a customer order and productivity delivery, customer preference rankings compare to competitor, response time to a service sell, time to develop new products, employee satisfaction, number of customer complaints (Warren and Reeve, 1997). The last two information aforementioned also written in KEP-431/BL/2013 by BAPEPAM-LK on CSR disclosure section.

2.2.2. Purpose of Disclosure

There are three purposes of disclosure: (1) protective; this idea came up since not all of the users are sophisticated enough to understand or process the information. So this becomes authorities' consideration to do supervision, since they act on behalf of public interest; (2) informative; the idea based on the sophisticated-intended users so the disclosure will be able to help them make a decision effectively. The authorities made a standard of how much information should be disclosed; (3) differential; this is the combination of the two previous purposes. What should be publicly disclosed should also benefit the intended users while some specific information should be delivered to the authorities.

Regulation plays an important role since the companies funding come from public through capital market. BAPEPAM-LK acts as a capital market regulator in Indonesia. They cooperate with standard setters to determine the scope of disclosure; specifically to fulfill the informative purpose. The existence of the two bodies to make disclosure standards usually called as dual governance structure. BAPEPAM-LK's authority usually limited to the routine reporting such as annual report; while standard constituent body such as FASB is authorized to determine the disclosure format in general financial disclosure. FASB also authorized to determine of the amount of information should be presented in financial report.

Qualified accounting information is useful for the investor to lower information asymmetry. Beaver in Puput Tri Komalasari (2001) stated that information asymmetry is a term to describe the two investors' condition in shares trading which one is more informed and the other is less informed. Information asymmetry is related to the investment decision. The more information presented in financial report; the lower the information asymmetry between companies and users. According to FASB, companies should provide information that is useful to investors and creditor so they can make rational decisions. The things to be considered by regulator in order to make a standard of the disclosure scope are: purpose of disclosure, benefit to the users compared with the administrative cost spent by issuer, economic cost by issuers, information overload, and clear identification of users need. FASB stated that information being disclosed in financial reports should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.

2.2.3. Level of Disclosure

Level of disclosure is related to how much information should be disclosed. There are three levels of disclosure proposed by Hendriksen and Brenda (1992), which are:

a) Adequate Disclosure

This implies a minimum amount of disclosure congruous with the negative objective of making the statement not misleading.

b) Fair Disclosure

This implies an ethical objective of providing equal treatment for all potential readers.

c) Full Disclosure

This implies the presentation of all relevant information. For some, it means the presentation of superfluous information that sometime becomes inappropriate.

Some people argued that too much information is harmful. One of the reasons is because it presents unimportant details that could hide the significant information. Too much information also makes the financial reports difficult to interpret. Users may not be able to focus on the priority information they should pay attention. It also may confuse the users with much information that may be irrelevant.

2.2.4. Method of Disclosure

Disclosure involves the entire process of financial reporting. However, several different methods of making disclosure are available.

The selection of the best method of disclosure in each case depends on the nature of the information and its relative importance. The common methods of disclosure according to Hendriksen and Brenda (1992) can be classified as follows:

1. Form and arrangement of formal statements
2. Terminology and detailed presentations
3. Parenthetical information
4. Footnotes
5. Supplementary statements and schedules
6. Comments in the auditor's report
7. The letter of the president or chairman of the board

2.2.5. Type of Disclosure

There are two type of disclosure: voluntary disclosure and mandatory disclosure. Voluntary disclosure is disclosure that implemented by company beyond what is required by accounting standards or legislation. While mandatory disclosure is disclosure that implemented by company due to the regulations or accounting standards.

In Indonesia, publicly listed companies in Indonesia Stock Exchange should disclose its report periodically. Those which are not bound by the regulation, such as private companies, are also allowed to disclose its financial report. This is one of the practices of voluntary disclosure. Another example is when public companies disclosed items voluntarily without required by regulation. IFAS stated that other information or additional information, such as company's uncertainty condition and environment report, is recommended to be disclosed (not mandated) and also needed in order to present a fair and relevant disclosure for users. A broader voluntary disclosure can also be a way for company to present its credibility since it helps investors to understand business management strategy.

BAPEPAM-LK made a regulation about presentation and disclosure guidance of financial report of listed or a public company for each industry through *Surat Edaran Ketua* BAPEPAM No. SE-02/PM/2002. It requires public companies to disclose its annual report which further will be available for public. This is a practice of mandatory disclosure. Companies will at least disclose certain information required by regulation. According to *Keputusan Ketua Badan Pengawas Pasar Modal dan Lembaga Keuangan* No. KEP-431/BL/2012 about the submission of annual report by public companies, the items that should be disclosed in annual report are:

1. Financial highlight
2. Board of Commissioners' report
3. Board of Directors' report
4. Company profile
5. Analysis and discussion of management
6. Corporate governance
7. Corporate social responsibility

8. Audited financial statements
9. Statement of responsibility of the Board of Commissioners and Board of Directors for the accuracy of the content of the annual report

The KEP-431/BL/2012 is issued as a replacement of KEP-134/BL/2006. The refinement of the regulation has a purpose to increase the quality of information transparency in annual report on public companies. One of the new things regulated is the disclosure of CSR activities. CSR disclosure was a part of corporate governance section, but now the CSR disclosure should be presented alone in separated section. The new regulation also requires company not only to disclose the activities and cost incurred but also with the policies made by the companies for four different aspects which are environment, employment practices, social and community development, and product responsibility.

2.3. Corporate Social Responsibility

There are two aspects of corporate social responsibility: making a profit and providing social services. Those aspects seems in line with the definition stated by Lantos (2011) that said corporate social responsibility as a social contract between corporations and society, based on long-term social demands and expectations. Ludescher and Mahsud (2010) proposed three definitions regarding corporate social responsibility which are: any activity that promotes the welfare of any stakeholder of a business corporation, philanthropic programs targeting communities or employees, and a variety of activities designed to enhance environmental stewardship (sustainability). Despite the fact that there are so many definitions about CSR, the underlying cause is that CSR involving not only the shareholder, but also the stakeholder. The stakeholder takes their own part on CSR based on their own interest. Cambridge Dictionaries defines stakeholder as a person who is involved with an organization and therefore has responsibilities towards it and an interest in its success.

To achieve and maintain profitability, business have found that they must produce quality products, operate efficiently, and be socially responsible and ethical in dealing with customers, employees, investors, government regulators, the community, and society. There are so many business concerned about how the production and distribution of their products affect the environment. For example Hewlett-Packard Company recycled nearly 250 million pounds of hardware and print cartridges globally in 2007 in order to minimize their waste which could harm the environment. Company really should pay attention to its stakeholder, in this case through the CSR activities.

There are three general principles of corporate social responsibility proposed by Basu and Palazo (2008): stakeholder driven, performance driven, and motivation driven. Then it reinterpreted further by Kreng and Huang (2011) as: a) consumer-behavior driven: treating all consumers equally, doing no harm to and being honest with stakeholders; b) corporate-strategy driven: establishment by an enterprise of a system that values a culture of ethics and support, internalizing the external demands into employee qualities; fulfilling mission within the enterprise, and acting as a societal model externally; c) public-policy driven: using resources authorized by societies efficiently, and creating additional value for societies. The reinterpretation itself already represents the entire subject of CSR.

The Economist Magazine suggested that CSR one a do good-ing sideshow and now it seen as mainstream, but as yet too few companies are doing well. This means that CSR have an integral correlation in determining business strategy. CSR in Indonesia considered reached it height of glory in 2005 when CSR Award was first held. Indonesia also became the first country who requires CSR activities to companies by adding chapter 74 on the Act of Limited Liability Companies which discussed specifically about CSR.

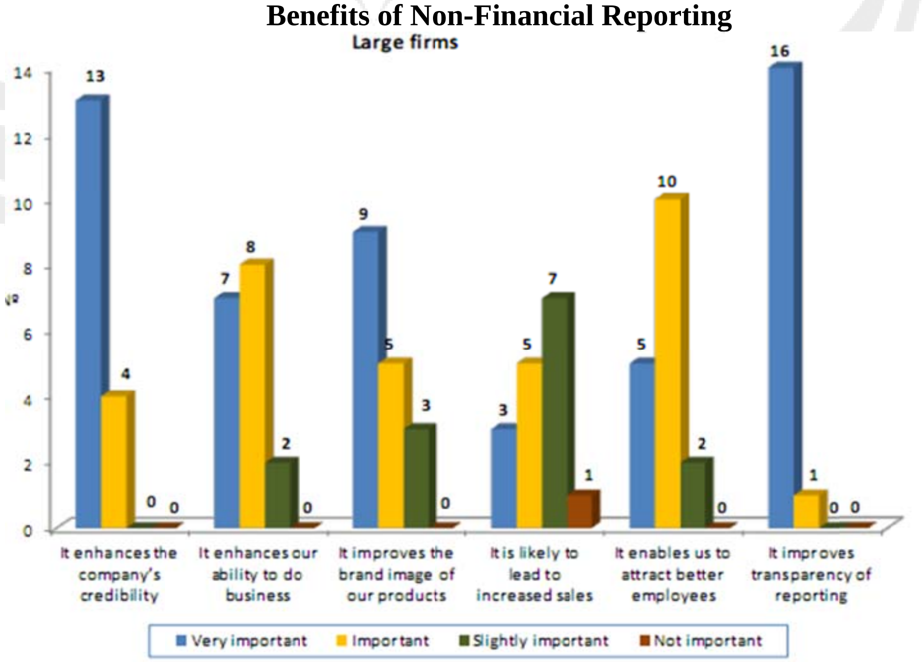
The Three Bottom Line aforementioned about profit, planet, and people also represent the role of CSR itself. Take an example of a cigarette manufacturer; they implementing CSR in many areas such as education, sport, environment, and art. The company may perform their CSR through a scholarship program, hosting a sport event, or planting thousands of trees. It is undeniable that CSR build the company reputation, so that many companies vying to perform their best CSR strategy. The things that make this activity still exist though society know what are their purpose is because the society can directly take benefit out of it as well as the company can be more developed; or in another word, CSR has a symbiosis mutualism – benefit both parties.

2.4. Corporate Social Responsibility Disclosure

The information disclosed by companies is not only on financial performance but also non-financial performance. The disclosure of such non-financial information usually takes place through Sustainability or Corporate Social Responsibility reports. Ernst and Young (2009) defines non-financial or sustainability reporting as the practice of measuring, disclosing and being accountable to internal and external stakeholders for organizational performance towards the goal of sustainable development. This reporting activity perceived to benefits the organizations in terms of stakeholder engagement and reputation.

Centre for Strategy and Evaluation Services (CSES) done a study about non-financial reporting. They gave some statements of the benefits of non-financial reporting to be chosen by large companies. Details of responses by large companies are show in Figure 2.1.

Figure 2.1
Benefits of Non-Financial Reporting



The figure above indicates that large firm thought “It enhances the company’s credibility” and “It improves transparency of reporting” were very important. While the least reaction is the suggestion that non-financial reporting would lead to increased sales. The results are quite similar with what many academicians stated; that non-financial reporting may have an indirect relationship in adding more value of the company in certain way.

The non-financial information regulation which may vary in every country makes it harder to compare one disclosure to another. A guideline issued by Global Reporting Initiative (GRI) is the most renowned guidelines used by companies despite the fact that there are so many guidelines available. The guidelines at the mean time can help the users to determine the value of the disclosure. Indonesian government regulations also can be used by companies as guideline. Act No. 40 of 2007 give a regulation about including corporate social responsibility- as an example of non-financial information- report in the annual report. Other regulation such as Keputusan Ketua Badan Pengawas Pasar Modal dan Lembaga Keuangan No. KEP-431/BL/2012 specifically set corporate social responsibility as one of the disclosure items.

According to Gray, Owen, and Maunders (1998) as cited by Sulistyowati (2004), the purposes of corporate social responsibility disclosure are:

a) To improve company’s image
b) To improve organizations’ accountability, with an assumption that there is a social contract between organization and society.
c) To inform the investors

The reasons of companies disclosing its corporate social responsibility according to Zadex (1998:1426) as cited by Sulistyowati (2004) are:

a) To understand whether the company already tried to achieved the best social performance
b) To know what has company done to improve social performance
c) To understand the implication of what company done

The advantages of commitments of the company to implement, present, and disclose CSR information is proposed by Lako (2010:103). He stated that company will get the advantages of: (1) more solid profitability and financial performance; (2) increasing the accountability and positive appreciation from investors, creditors, suppliers, and consumers; (3) increasing of work ethic commitment, efficiency, and employee productivity; (4) decreasing of vulnerability of social unrest and community resistance from the feeling of appreciated by the company; (5) increasing the reputation, corporate branding, goodwill (intangible asset) and long-term company value.

Analyst is one of the company's disclosure users. They may not be the primary users but they have an important role as well. Analyst is an independent party who following some companies and make an earnings forecast. Traditionally, the substantial theoretical and empirical literature on analysts' forecast has focused primarily on the value relevance of financial information and financial disclosure in the production of analysts' forecasts. The earnings forecast made by analysts nowadays shifting from that traditional way. CSR disclosure as one of the non-financial disclosure also has gotten the attention from analysts. It helps analysts to get broader information since it not only present a certain amount of number but also the explanation behind the number.

2.5. Earnings Forecast

Information about stock price and return are very important for investors. The importance of that information can be seen in the study done by Ball and Brown (1968) in which earnings have an influence on corporate income. Earnings can be defined as the profit which produces from company in certain period. According to Burgstahler and Dichev (1997), market value and earnings have a positive relationship that is where the earnings increases, the function of market value also increased.

Earnings forecast are based on analysts' expectations of company growth and profitability. Analyst will examine some factors such as economic growth rates, currencies, and other macroeconomics factors that influence corporate growth. Hope (2002) documented that financial disclosure quality is positively related to analyst forecast accuracy. Future earnings growth estimation is a major key to successful long-term stock investing.

Analysts' forecasts mostly used as a proxy for the market's expectation for earnings and practitioners require accurate earnings forecasts in many stock valuation models. Hope (2002) in his research focuses on professional analysts as they are one of the most important users of financial reports. In some countries, the increasing interest in the work of financial analysts is documented.

Investors are especially interested in estimating uncertainty about future earnings because it reveals important characteristics of the firm's information environment prior to the release of accounting results. Earnings forecast are mostly made by independent parties. That would also be the reason why investors rely on it; independent parties have no interest in forecasting good or bad earnings. The neutrality plays an important role of how much trust should investor put in their forecast. Companies forecast are usually done by more than one analyst. The more analysts follow a company, the more likely the forecast to be reliable.

Further, there's a term of consensus earning. Consensus earnings estimates perceived far from perfect but surprisingly watched by many investors and play important role in measuring the appropriate valuation for a stock. A consensus forecast number is normally an average or media of all the forecast form individual analysts. The earnings forecast are mostly presented in annual basis, but quarterly basis also sometimes be used.

As a result of the uncertainty of earnings forecast, the analysts' forecast error is comprised of an error due to imprecise public information and an error due to imprecise private information. As the consequences, earnings forecast uncertainty includes two components that correspond to the two types of analyst forecast errors. The two types are: (1) impact of unanticipated aggregate shocks that affect earnings from the time a forecast is made until the end of the fiscal period over which actual earnings are realized, and (2) analysts' information processing skills and different forecasting models.

2.6. Legitimacy Theory

Legitimacy theory give a basic framework of how important stakeholders' legitimacy toward the company in order to keep the company going concern. Deegan (2002) defined legitimacy as:

> "a system-oriented perspective, the entity is assumed to influenced by, and in turn to have influence upon, the society in which it operates. Corporate disclosure is considered to represent one important means by which management can influence external perceptions about organization."

This theory perceived that a company can operate by the legitimacy of society, where it can be taken back by society if they think the company can't fulfill its obligation. CSR is seen as an obligation approved by company and society. For instance, society gave permission to the company to use its resources as long as the company can adapt to the demand changing from society (Walden and Scwartz, 1997).

Gary, Kouhy, and Lavers (1994) stated that the influence of society can define the financial and other resources allocation. So the company tends to use an environmental-based performance and the environmental information disclosure to legitimate its activities. Legitimacy theory focuses on the relationship between companies and society. Dowling and Pfeffer (1975:122) proposed a logical reason said that organization is trying to create a harmony between social values attached on its activities with norms of behavior live in the society social systems; which the organization is a part of the system. As long as the two systems walk in harmony, it can be seen as company legitimacy. Otherwise, the disharmony will cause a threat to company legitimacy.

The annual report became a way for companies to create the image of environmental responsibility to make society accept them. Start with the acceptance, hopefully society will give an additional value to company. For example through take a part of any partnership program with company. This gesture may give an idea to the analyst as if in the future the company will still exist, or even makes more profit with the legitimacy given by society.

2.7. Hypothesis Development and Previous Research

There is not many research about CSR disclosure or non-financial reporting relationship to earnings forecast. Mostly, people only tested on the relationship of earning forecast to financial indicators in financial reporting. Several researchers who study either non-financial reporting or analysts' earnings forecast accuracy are:

Table 2.1

Result of Previous Research

No.	Researcher (year)	Title	Variables	Result
1.	Dhaliwal et al. (2012)	Nonfinancial Disclosure and Analyst Forecast Accuracy: International Evidence on Corporate Social Responsibility Disclosure	Dependent Variable: CSR disclosure Independent variable: analyst forecast, stakeholder orientation, financial transparency	CSR disclosure proved to be increasing analysts' forecast accuracy. The relationship is even stronger in stakeholder-oriented countries and more opaque financial disclosure.

2.	Hope (2002)	Disclosure Practices, Enforcement of Accounting Standards and Analysts' Forecast Accuracy: An International Study	Dependent variable: analysts' earnings forecast accuracy Independent variable: annual report disclosure, enforcement, accounting choice and analyst following,	Strong enforcement is associated with higher forecast accuracy which also reduces analysts' uncertainty about future earnings.
3.	Lang and Lundholm (1996)	Corporate Disclosure Policy and Analyst Behavior	Dependent variable: firms' disclosure policy Independent variable: number of analyst following, dispersion of analysts' earnings forecast, accuracy of analysts' earnings forecast, volatility of analysts' earnings forecast revisions	Firms with more informative disclosure policies have more analyst following, more accurate analyst earnings forecast, less dispersion among individual analysts forecast and less volatility in forecast revisions.

The relationship between financial information disclosures to earnings forecast is undoubtedly positive. There are many researches on that area since the financial indicators make it easier for analysts to forecast earnings. One of the financial information used to make analysis is economic growth. Since financial information disclosures already help the analysts enough to forecast earnings, the reasons and benefits of disclosing non-financial information is questioned; in this case is CSR disclosure. The non-financial disclosure is merely only for obeying regulations and satisfying stakeholders.

Analysts allegedly utilize the non-financial disclosure as additional information to the financial one. For example, analyst once forecasted Shell’s earnings and there was a case of Shell which is boycotted by Greenpeace due to company’s decision to dump an oil platform in the Atlantic. As the result of this boycott, the 70 percent sales dropped. If analysts didn’t consider this issue while making decision, it may lessen the forecast accuracy. Aware of such information may help analyst to make a more accurate earnings forecast.

CSR information is going to be a useful input for analyst in making their forecasting process to the extent that CSR activities affect firm value. CSR activities can affect financial performance through various channels, including sales, costs, and operational efficiency, financing, and litigation risk. The result of research done by Dhaliwal et al. (2011) stated that publishing CSR report subsequently experience a lower cost of equity. Firm with good CSR performance gain benefits in the capital market. Waddock and Graves (1997) in their journal about the corporate social performance and financial performance link found that social performance is positively associated with future financial performance. By including most the S&P 500 firms as their data set, they evaluated the linkage between financial and social performance when corporate social performance was both dependent and independent variable. They found that the corporate social performance does depend on financial performance and the sign of the relationship is positive. Thus, firms with available resources may choose to spend those resources by doing well and the resource allocation may resulted in improved corporate social performance overall. They also found (in a kind of simultaneous relationship) that financial performance also depends on good social performance; suggesting that there is something about performing well in social arenas that may be simply linked to good managerial practices. The research done by Deloitte in 2003 supporting the statement that analyst does use CSR-related information. Deloitte surveyed around 400 mainstream fund managers and financial analysts in nine European countries. The result is 80 percent of the respondents indicated that CSR-related activities (such as social and environmental management) have a positive impact on a company's market value in the long term, and around 50 percent of the respondents indicated that they use the CSR information provided by management.

There is any, although few in number, research about how non-financial disclosure improves earnings forecast accuracy. As what mentioned previously that non-financial disclosure consist of many kind of information. This research wants to specify the non-financial disclosure to the extent of CSR disclosure since Indonesian publicly listed company mandatorily should disclosed its CSR activities. The benefit of CSR disclosure to the issuing company is still uncertain. Some of the CSR-related nonfinancial information in CSR report may also be available in other part of annual report of the public media. However, the compilation of CSR reports indicates an effort made by firms to issue such information; which the existence of this report is likely to represent a greater amount and better availability of the information to analysts.

This research will test the relationship between corporate social responsibility and earnings forecast accuracy. The result may imply negative, neutral, or positive relationship. Neutral relationship may happen due to the intervention of unexpected variables between corporate social responsibility and earnings forecast accuracy. There is no research resulted in negative relationship between corporate social responsibility disclosure and earnings forecast accuracy yet. However, this research anticipated the negative relationship since Dhaliwal et al. (2012) specifically used an issuance of stand-alone CSR reports while this research uses the amount of CSR-related information disclosed.

The positive relationship proposed by Dhaliwal et al. (2012) that the issuance of stand-alone CSR report resulted in higher analysts' earnings forecast accuracy. They suggest that non-financial disclosure is not only associated with a better information environment, as measured by analyst forecast accuracy, but also complements financial disclosure by mitigating the negative effect of financial opacity on forecast accuracy.

From the discussion above and refer to previous researcher, this study formulate following hypothesis:

Ha: Corporate social responsibility disclosure affects earnings forecast accuracy