# CHAPTER I

# INTRODUCTION

## 1.1. Background

As the world develops, competition among firms becomes tighter, and market demands are getting harder to be satisfied, firms are in extremely high pressure. Firms nowadays are not only required to strive for profitability. They also are demanded to contribute to their social relations, corporate governance, and impacts on the environment. Tanudjaja (2006) argues, it is known indeed, that the industrial sector or the big scale corporations have contributed to economic growth of the nation. However, the exploitation of natural resources by the industrial sector often results in severe environmental degradation.

The increasing demands that the firms should pay attention to the social and environment has started since the publication of Global Reporting Initiatives in 2000 and ISO 26000. Regulations concerning the corporate social responsibility (CSR) are also made by governments of many nations around the globe in order to "force" the firms to engage in CSR. In addition, most of the major international organizations such as the United Nations, World Bank, Organization of Economic Co-operation and Development, and International Labor Organization do not only endorse CSR, but have also established guidelines and permanently staffed divisions to observe about and promote CSR (Lee, 2008).

Indonesia is one of the nations that has already regulated CSR in Law of 40/2007 paragraph 74 on Limited Liability Corporate and Government Regulation of 47/2012 on Corporate Social and Environmental Responsibility. The Constitution Court concluded that CSR is mandatory for Indonesian resource-based firms. The consideration was that the operation has caused social and environmental damages in previous time because the firms had neglected social and environmental aspects that resulted in disadvantages to the surrounding communities in particular and the environment in general (Hendarto and Purwanto, 2012).

In addition to the regulation, in this era of rapid access of information, the media also contributes to the increasing awareness of environmental and social activities that firms engage in. Once a firm causes an environmental damage, has conflict with surrounding inhabitant, or harms its employees, the media will immediately expose and highlight the case. Servaes and Tamayo (2013) found that firms with high public awareness can be penalized more when there are CSR concerns as mentioned. Therefore, it will worsen the firm's image that it will not support the firm's operation, productivity, and profitability. It is then acknowledged that firms as business people will not survive if it neglects the surrounding conditions where it is located (Tanudjaja, 2006).

In trying to meet the regulation and public pressures, firms will disclose their CSR activities in the annual report. Investors who pay attention to the CSR activities of the firms or known as green investors (Ghoul et al.,

2011) would consider the CSR activities of the firms they are investing in. On the contrary, those who do not consider CSR activities might keep investing even if firms have bad reputation of doing harmful activities to the environment. Thus, the information regarding the CSR activities disclosed in the annual report will have impact to the market reaction because investors might base their investment decision on the disclosure of the CSR activities.

Many researches have been widely conducted regarding the impact of CSR to market reaction. Hendarto and Purwanto (2012) found that Indonesian firms undertaking voluntary CSR activities gain positive abnormal return when the announcement of mandatory CSR is released. Cheng and Christiawan (2011) concluded that CSR disclosure has significant impact on abnormal return which indicates that investors consider the CSR in making decisions. Karagiorgos (2010) found a positive correlation among stock returns and CSR performance in Greek firms.

Different results are also obtained by other researches. A study by Flammer (2013) found that the positive (negative) stock market reaction to eco-friendly (harmful) events is smaller for companies with higher levels of environmental CSR. Brammer et al. (2005) concluded that composite social performance indicators were negatively related to stock returns. They also found that firms with poor financial reward are the ones with good social performance on the employment and to a lesser extent the environmental aspects. Muid (2011) found out that only the social CSR variable that has positive influence on stock return, while the environmental CSR variable does not affect the stock return. The simultaneous result with control variables indicates that both environmental and social CSR variables positively affect the stock return.

Since doing CSR activities needs cost, firms should allocate a certain number of funds so that they are able to conduct and disclose their CSR activities. Therefore, as agency theory argues, the more profit a firm generates will lead to broader disclosure of its social information because more profit enables firms to do more CSR activities. However, from the legitimacy theory viewpoint, profit has negative effect towards the disclosure of CSR. The reason is that because firms with higher profit will find it not necessary to disclose information other than the good financial performance of firms. Only when the profit is low will the firms find the necessity of disclosing more CSR activities because they expect that the report user will obtain “good news” of the firms’ performance. Through this research, it can show how profitability impacts the relationship of CSR disclosure and market reaction.

When profitability is used as moderating variable, Kusumadilaga (2010) found that profitability does not affect the relationship between CSR and firm value. Wirokosumo (2011) concluded that CSR disclosure has relatively low negative impact to the firm value. When profitability is included as the moderating variable, it results in no impact to the relationship of CSR disclosure and firm value. The research of Rosiana et al. (2013) shows that CSR affects the firm value positively and the profitability can strengthen the influence of CSR disclosure toward firm value. Although there appears to be more support for the view that CSR activities are positively related to profitability and firm value, a large number of studies find the opposite relation. As a result, the normative implications of research on corporate social responsibility are still uncertain (Servaes and Tamayo, 2013).

Because of different results obtained and two-sided perspectives about how CSR disclosure impacts market reaction, this research is aimed at examining the impact of CSR to market reaction, which is moderated by profitability to see whether the profitability affects the relationship of both variables. This research uses the same sample as Cheng and Christiawan (2011) which consists of firms engaging in natural resources business. In addition to the obligation for those firms to disclose the CSR as regulated in Law of 40/2007, these firms are the ones whose operation have caused social and environmental damages in previous times that they get most attention of public because their operation is potentially affecting the society as a whole (Cheng and Christiawan, 2011).

## 1.2. Research Questions

Green investors increase the demand for stocks of firms that exhibit better social responsibility (Ghoul et al., 2011). Based on that finding, the research question formulated is: “does profitability positively impact the relationship between CSR disclosure and market reaction?”

## 1.3. Research Objective

This research is aimed at examining and proving empirically whether profitability has positive impact to the relationship between CSR disclosure and the market reaction.

## 1.4. Research Contribution

This research is expected to contribute in some aspects as follows:

1. Theory

   Regarding the theory, this research is to emphasize the importance of CSR to the development of the business world ahead. It also can be used as a reference for further researches.

2. Practical

   Investors can use this research to know the impact of CSR to the market reaction and to make investment decisions by considering the CSR. Firms are also expected to know the importance of CSR disclosure to their stock prices that they can give more concerns to their social relations.

3. Society

   This research tries to give encouragement to society that they can be more proactive in recognizing their rights and obligations, and to control firms' activities, especially in their social responsibility so that the society, environment, and firms can be more synergized (Wirokosumo, 2011).

4. Policy

   The policy makers, both the government and the firms themselves, can take this research in their consideration in making policy in order to embody much proper CSR, not merely because of the requirement to obey the regulations, but also because they realize the importance of the environment.

## 1.5. Data Analysis

In doing the research, several steps as follows are implemented, such as:

1. Data collection

   The research uses secondary data in the form of annual report and stock price of resource based firms that are listed in Indonesian Stock Exchange (IDX) from 2007 until 2013. The data are taken from Kantor Bursa Efek Indonesia at Mangkubumi Street 111, Yogyakarta and/or downloaded from *www.idx.co.id* and *www.yahoofinance.com*.

2. Measurement of each variable

   Each variable is calculated by the following set of measurements.

   a. Corporate Social Responsibility is measured using indicators that are based on the Global Reporting Initiative (GRI) index.

   b. Profitability as moderating variable is represented by return on assets (ROA) which is calculated by net income divided by total assets.

c. Market reaction is calculated using the cumulative abnormal return which is derived from the total difference between the actual and expected return on share.

d. The control variables:

1) Price to book value (PBV) is measured by stock market price divided by the book value per share.
2) Debt to equity ratio (DER) is calculated by total liabilities divided by total equity.
3) Firm size is represented by natural logarithm of total assets.

## 1.6. Writing Structure

This paper contains the following parts:

**CHAPTER I INTRODUCTION**

This chapter contains background, research questions, research objective, research contribution, and writing structure.

**CHAPTER II LITERATURE REVIEW AND HYPHOTHESES DEVELOPMENT**

The chapter consists of theories and previous researches regarding the topic of the research. Those theories and previous researches are then used as base to develop the hypotheses.

**CHAPTER III RESEARCH METHODOLOGY**

The chapter discusses the used sample, data collection technique, and the data analysis method.

**CHAPTER IV DATA ANALYSIS**

Explains how the collected data are analyzed as well as the result of the analysis.

**CHAPTER V CONCLUSIONS**

The chapter comprises conclusion, limitation of research, and suggestions.