CHAPTER II

LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

2.1. Financial Reporting

SFAC No. 1 Paragraph 6 states that financial statements are a central feature of financial reporting. Although financial statements may also contain information from sources other than accounting records, accounting systems are generally organized on the basis of the elements of financial statements (assets, liabilities, revenues, expenses, etc.) and provide the bulk of the information for financial statements. The financial statements now most frequently provided are (a) balance sheet or statement of financial position, (b) income or earnings statement, (c) statement of retained earnings, (d) statement of other changes in owners' or stockholders' equity, and (e) statement of changes in financial position (statement of sources and applications of funds).

While the financial statements may also contain information from sources other than accounting records, SFAC No. 1 Paragraph 7 explains that financial reporting includes not only financial statements. It also includes other means of communicating information that relates, directly or indirectly, to the information provided by the accounting system – that is, information about an enterprise's resources, obligations, earnings, etc. Management may communicate information to those outside an enterprise by means of financial reporting other than formal financial statements either because the information is required to be disclosed by authoritative pronouncement, regulatory rule, or custom or because management considers it useful to those outside the enterprise and discloses it voluntarily.

2.1.1. The Objective of Financial Reporting

The objective of financial reporting based on SFAC No. 8 is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit (SFAC No. 8 Chapter 1: OB2).

Suwardjono (2010) mentions the three primary objectives of financial reporting based on FASB concept are as follows:

1. Financial reporting should provide useful information for investors and creditors as well as other users, both the continuous and potential ones, in making investments, credit, and other rational decisions. The information should be understood by those who have adequate knowledge about various business and economic activities, and who are willing to learn the information diligently.
2. Financial reporting should provide information to help investors and creditors as well as other users, both the continuous and potential ones, assess the amount, event and the uncertainty of prospective cash receipts from dividend or interest and future proceeds from sales, redemption, or the due date of security or loans. In other way, financial

reporting should provide information to help investors and creditors as well as other users assess the amount, the event, and the uncertainty of net cash inflows to the firm.

3. Financial reporting should provide information about economic resources of a firm, the claims to those resources, and the effects of transactions, events, and conditions that change the resources of the firm and claims to those resources.

Always, the emphasis is on providing information to enable the users to make economic decision (Damant, 2002). Through those objectives, the users are expected to be able to make the right decisions that correspond to their interests respectively.

2.1.2. Disclosure in Financial Reporting

Disclosure is the process of communicating any information regarding the firms that is provided through financial reporting and other media. SFAC No. 1 Paragraph 7 states that information communicated by means of financial reporting other than financial statements may take various forms and relate to various matters. Corporate annual reports, prospectuses, and annual reports filled with the Securities and Exchange Commission are common examples of reports that include financial statements, other financial information, and nonfinancial information. News releases, management's forecasts or other descriptions of its plans or expectations, and descriptions of an enterprise's social or environmental impact are examples of reports giving financial information other than financial statements or giving only nonfinancial information.

Wolk et al. (2001) in Suwardjono (2010) defines the disclosure as follows:

> *Broadly interpreted, disclosure is concerned with information in both the financial statements and supplementary communications including footnotes, 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.*

Disclosure is also defined as providing the information more than what has been provided in formal financial statement (Suwardjono, 2010). This is because some useful information is better provided by financial statements and some is better provided, or can only be provided, by means of financial reporting other than financial statements as stated in SFAC No. 1 Paragraph 5.

Generally, the main purpose of disclosure is to provide information to the users. In his book, Suwardjono (2010) states that there are three purposes of disclosure, namely:

a) Protective purpose

   This purpose explains that disclosure is intended to protect the action of management that might be unfair. The reason is because not all the users have the same extent of information about the firms. This is as a consequence of the information asymmetry which is explained by the agency theory arguing that there is a separation between principal (the owner) and agent (the management). Because the principal delegates the work to the agent, the principal might not know exactly what the management has done because both the principal and the agent have their own interests respectively. Thus, disclosure is done in order to minimize the lack of information that might be possessed by the principal or financial reporting users, so that they are able to obtain better information about the firm. This purpose of disclosure enables a higher extent of disclosure.

b) Informative purpose

The main idea of informative purpose is that the users are adequate enough to use the information. Therefore, the disclosure is intended to provide information that is supportive to the effectiveness of the users' decision making. This is supported by SFAC No. 1 Paragraph 34 stating that financial reporting should provide information that is useful to present and potential investors, creditors and other users in making rational investment, credit, and similar decisions. The information 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.

c) Differential purpose

Differential purpose is the combination of protective and informative purposes. The items to be disclosed to the public are limited by what is perceived as useful to the users. In fulfilling this purpose, the protective and informative purposes must be served. Regarding the limitation of what is perceived as useful to the users, it is explained by the statement that in the last analysis, each decision maker judges what accounting information is useful, and that judgment is influenced by factors such as the decision to be made, the methods of decision making to be used, the information already possessed or obtainable from other sources, and the decision maker's capacity to process the information. Therefore, optimal information for one user will not be optimal for another (SFAC No. 2, p. 1).

2.2. Corporate Social Responsibility

In addition to generating profit, firms are also obliged to be responsible for other things that might be the demands from shareholders, government, and society. These responsibilities among others are paying the taxes, enhancing shareholders' wealth, including the obligation to do the corporate social responsibility.

There has been no universally accepted definition of corporate social responsibility (CSR). Consequently, academics and practitioners have thus been free to define and interpret CSR as best fits their purpose, resulting in definitions and interpretations that are often biased by underlying value-judgments and ideologies. Therefore, a good and usable definition of CSR especially when used in developing theory, is one that does not interpret what the responsibilities of the firm should be (Kristoffersen et al., 2005).

The World Business Council on Sustainable Development (2000: 8) defines CSR as "the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as of the local community and society at large". Based on the definition proposed by Carroll (1979), CSR encompasses the economic, legal, ethical, and discretionary expectations that society has of an organization at a given point in time. The most basic of these, in an evolutionary sense, is the economic responsibility the firm holds towards its shareholders, and the legal responsibility the firm holds toward society. Firms may also assume ethical and discretionary responsibilities towards society. Ethical responsibilities reflect societal norms and values that are not codified in law, and discretionary responsibilities reflect issues for which society sends no clear message. (Kristoffersen et al., 2005).

2.2.1. Theory and Practice of Corporate Social Responsibility

Firms are expected not to only concern about the management and shareholder (investors and creditors) but also employees, customers, and society. Firms have the social responsibility to the parties outside the management and shareholders (Anggraini, 2006). This understanding expands the organizations' responsibility (especially firms), beyond its traditional role to provide financial reports to the owner of the capital, especially shareholder. The expansion is made by assuming that firms have broader responsibility instead of only seek for shareholder profit (Gray et. al., 1987; Sembiring, 2005).

There is a shift in the philosophy of the management of the business entity which was formerly based on the agency theory, where it was believed that the firm was only responsible to management (agent) and owner (principal) (Politon and Rustiyaningsih, 2013). Since the agency theory only emphasizes the responsibility of the firm's manager to the principal, the managers will mostly focus on maximizing the shareholder wealth that the social and environmental aspect is more likely to be ignored.

There is a significant difference in how the literature describes CSR before and after the 1970s. Before the 1970s CSR is described as a virtue, driven by mainly the corporations themselves, with the objective of appealing to regulators and the public in the pursuit of goodwill, or alternatively to simply further personal political agendas (Levitt, 1958; Kristoffersen et al., 2005). The advent of societal change starting at the end of the 1960s and beginning of the 1970s appears to have shifted the drivers behind CSR away from the corporations and into the hands of the public, as stakeholder activism gained momentum. Hence, CSR changed from being mainly supply-driven to becoming significantly more demand-driven (Kristoffersen et al., 2005).

The trend in higher engagement of CSR in economic element can be explained by the stakeholder theory, with the tendency of corporate management to meet the expectations of powerful stakeholders (Deegan, 2009; Razafindrambinina and Sabran, 2014). The term stakeholders refers to groups of constituents who have a legitimate claim on the firm (Freeman, 1984; Pearce, 1982; Hill and Jones, 1992). The central idea of the stakeholder theory is that an organization's success is dependent on how well it manages the relationships with key groups such as customers, employees, suppliers, communities, financiers, and others that can affect the realization of its purpose. It is the manager's job is to keep the support of all of these groups, balancing their interests, while making the organization a place where stakeholder interests can be maximized over time (Freeman and Philips, 2002). Stakeholders' expectations are likely to vary between countries, leading to different practices in CSR reporting (Darmadi and Gunawan, 2012).

Firms are believed to be a part of a larger economic system in which their operations will affect other components of the system, thus impacting the system itself as a whole (Sutanto, 2008; Razafindrambinina and Sabran, 2014). As a result, several governments, activists and the society as a whole are pressuring companies that commit costly irresponsible actions to alter the way they operate. The obligation for Indonesian firms to perform the corporate social responsibility (CSR) activities is regulated in Law of 40/2007 Article 74. It is stated that Indonesian firms that engage in and or are related with natural resources are obliged to do the social and environmental responsibility.

2.2.2. Disclosure of Corporate Social Responsibility Activities

It is aforementioned, as explained by SFAC No. 1 Paragraph 7, that financial reporting includes not only financial statements. It also includes other means of communicating information that relates, directly or indirectly, to the information provided by the accounting system, either because the information is required to be disclosed by authoritative pronouncement, regulatory rule, or custom or because management considers it useful to those outside the enterprise and discloses it voluntarily. Therefore, since it is required by the regulation, disclosure of corporate social responsibility should be done by the firms. In addition, the demands that firm should give transparent information, be an accountable organization, and should have good corporate governance make it a must for the firm to inform its social activities (Anggraini, 2006).

One of the ways to inform firm's social activities is through the sustainability report or through CSR disclosure in the annual report. The CSR disclosure which is also known as social disclosure, corporate social reporting, and social accounting (Matthews, 1995; Sembiring, 2005) is a communication process of social and environmental impacts to the certain groups and the society as a whole as the consequence of economic activities conducted by an organization (Sembiring, 2005).

There are two approaches that significantly different in observing the disclosure of the firm's CSR. First, CSR disclosure might be treated as a supplement of the conventional accounting activities. This approach will generally assume the financial society as the primary users of the firm's CSR disclosure and tend to limit the perception of the disclosed CSR activities. The second alternative approach is by putting the CSR disclosure on an examination of the role of information in the relationship of society and the organization. This broader perspective has been the main source of the development in the understanding regarding CSR disclosure as well as the main source of criticism toward the firm's CSR disclosure (Gray et. al., 1995; Sembiring, 2005).

There are two kinds of disclosure; mandatory and voluntary. Mandatory disclosure is the disclosure that is done by the firm as regulated by the government. The Law of 40/2007 Article 66 obliges all the firms to disclose social responsibility activities they have conducted in their annual report. However, the CSR items that should be disclosed have not been regulated thus the items disclosed are still voluntary (Cheng and Christiawan, 2011). Voluntary disclosure is the disclosure done by the firm out of what is obliged by the accounting standard or the government.

The signaling theory is the one that grounds the voluntary disclosure. Management always tries to disclose private information that is perceived as attractive to the investors and shareholders, especially when the information is perceived as good news. Management will be willing to disclose the information that can enhance its credibility and firm's success though it is not mandatory (Suwardjono, 2010).

2.3. Market Reaction

Because many people base economic decisions on their relationships with and knowledge about business enterprises and thus are potentially interested in the information provided by financial reporting (SFAC No. 1, par. 24), the two primary qualities that make accounting information useful for decision making are relevance and reliability. Information is said to be relevant if it has the capacity to make a difference in investors, creditors, or other user's decisions (SFAC No. 5, par. 74). To be reliable, information must be sufficiently faithful in its representation of the underlying resource, obligation, or effect of events and sufficiently free of error and bias to be useful to investors, creditors, and others in making decisions (SFAC No. 5, par 75).

To be relevant, information must be timely and it must have predictive value of feedback value or both (SFAC No. 2, p. 2). The feedback value from investors as the respond to the information disclosed in financial reporting is reflected in the market reaction. Information disseminated by a firm that is listed in a stock exchange will be responded by the market in particular extent. Referring to the efficient market hypothesis, a market is considered efficient when asset prices fully reflect all available information from historical, public, and private sources (Fama, 1991; Darmadi and Gunawan, 2012). In the semi-strong form of market efficiency, asset prices reflect both historical and public information. Further, when the market efficiency is weak, asset prices only reflect historical information. In a weak-form efficient market, investors are unlikely to make systematic nonzero profit by relying on past information. In other words, successive returns tend to be independent and follow random walks in such a market (Darmadi and Gunawan, 2012).

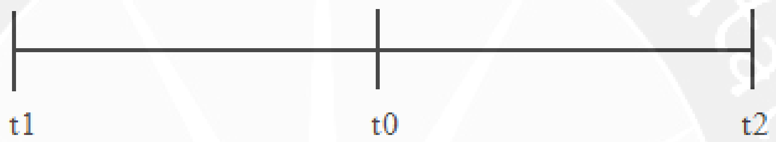
Market reaction shows investors' daily reaction to any kind of information that is seen in the stock price. Kelana and Wijaya (2005) in Cheng and Christiawan (2011), state that the trust of investors is one of the very influential aspects in the stock market. Thus, the disclosure is done to influence investors' decision. CSR disclosure done by the firms is expected to give signals and can enhance the firm value in investors' point of view. It indicates that firms implementing CSR expect to be responded positively by the market that it can maximize its long-term profit.

Information is said to be having value added if it results in reactions to do transaction in the stock market. It can be seen from the abnormal return which is one indicator that can be used to see the market condition. Abnormal return is the difference between actual and expected return (Jogiyanto, 2009; Cheng and Christiawan, 2011). Abnormal return will be positive if the return earned exceeds the expected return or the calculated return, and it will be negative if the return earned is less than the expected return.

Before determining the model to estimate expected return, it is necessary to determine several period terms as the basic estimation of the expected return. Those periods are estimation period; generally is the period before the event (event period), and the event period, which is the day where the event happens. It is illustrated in the picture as follows.

Graph 2.1

Event Period



There is no benchmark for determining the length of the estimation period (Jogiyanto, 2010; Cheng and Kurniawan, 2011). The common length used for estimation period is approximately 100-250 days for daily data. The event period or event window is the period where the event and effect happen. The event period presented in the picture is t0, while the window period is from t1 until t2. The length of window period depends on the type of the event. If the event’s economic value can be measured easily by investors, the window period can be short because investors can react quickly. On the contrary, 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, namely if the market has knew the information before the information is announced.

The expected return can be calculated using three estimation model without adjusted risk, namely (Jogiyanto, 2010 in Cheng and Kurniawan 2011):

a) Mean Adjusted Return

This model assumes a market is efficient and stock return is different randomly around the actual price.

b) Market Model Return

The calculation of expected return with this model can be done in two steps; 1) establish the expected model by using realization data during the estimation period, and 2) using the expected model to estimate expected return in the window period.

c) Market Adjusted Return Model

This model assumes that the best presumption to estimate stock return is the market index return on that time. By using this model, there is no need to use the estimation period to make the estimation model because the estimated expected stock return equals to the market index return. The expected return with adjusted risk is such as Capital Asset Pricing Model (CAPM). CAPM considers the market risks to adjust the expected return. The risks used in CAPM are the market risks or systemic risks measured by beta. CAPM formula is:

$$E\ \ Ri\ \ = Rf + \beta(Rm - Rf)$$

Where:

Rf : Risk free rate; average interest rate of Sertifikat Bank Indonesia

Rm: Market returns that commonly use stock price index (IHSG)

β : Beta of each stock

People engage in investing, lending, and similar activities primarily intend to increase their cash resources. The ultimate test of success (or failure) of those activities is the extent to which they return more (or less) cash than they cost (SFAC No. 1, par. 38). Therefore, the positive abnormal return will be preferable, not only to investors, but also to the firm itself because it means that the stock price increases. The increase in stock price means that the demand of the firm's stock is as well increasing thus the more attractive the firm is to the investors and the more cash inflows for the firm. One of the ways to make the firm look more attractive to the investors is through more disclosure of good news of the firm, such as good financial performance, awards achievement, including its social activities because it might give good news to the investors that the firm is also good at managing other things that are not merely about generating profit.

2.4. Profitability

Profit for any firm is the primary goal and without it, no firm can exist in the long-term. Not only will it result in firm's lower attractiveness to the investors, the absence of profit will also result in the lack of ability to do its operation. A firm's profit is the revenue after all the expenses are deducted.

Profit can be distributed to the shareholder in the form of dividends, or it can be reinvested in the firm.

While profit is the absolute amount of number resulting from the residual of revenue deducts all the expenses, profitability is the relative value of the firm's profit. It shows the firm's efficiency, and thus it shows whether the firm will succeed or fail. By that, it can be said that the firm that generates profit does not necessarily mean that the firm is profitable. Therefore, measuring a firm's profitability is a crucial part of firm's evaluation. So, profitability becomes crucial consideration to investors in their investment decision (Ang, 1997; Wahidahwati, 2002; Kusumadilaga, 2010).

Three ways are commonly used to measure the profitability. The three ratios are used to measure the efficiency of firms using their asset and how efficient they manage their operation. The focus is on net income (Ross et al., 2006; Wirokosumo, 2011):

1. Profit Margin

   Profit margin represents how much profit received in each one Dollar or one Rupiah of sales. High profit margin is very preferred.

$$Profit\ Margin = \frac{Net\ Income}{Sales}$$

2. Return on Assets

   Return on assets (ROA) shows how much a Dollar or Rupiah from assets. It indicates how efficient a firm is at using its assets to generate earnings (*www.investopedia.com*).

$$Return\ on\ Assets = \frac{Net\ Income}{Assets}$$

3. Return on Equity

   Return on equity (ROE) is the measurement of how much the cost the stockholders face in a year. It reveals how much profit a company is able to generate with the money shareholders have invested.

$$Return\ on\ Equity = \frac{Net\ Income}{Equity}$$

Numerous researchers use ROA as an indicator of operating performance. ROA captures a firm's ability to utilize assets efficiently, reflects general profitability of a firm and is a ratio that is often used for analysis by firms. Furthermore, it is free from short-term consideration of its owners regarding the size of the capital (Razafindrambinina and Sabran, 2014).

The profit that is commonly used to be distributed to the shareholders is the one after interests and taxes. The higher the profit earned, the greater is the ability of firms to pay the dividends. The managers do not only get dividends, but also will attain greater power in regulating the policy of firms. On the other hand, the power of managers (insider) will increase, moreover, they can even increase their ownership because of the dividends received is high as the results of high profit earned. In addition, more profit will allow the firm to do more activities, including its corporate social activities. Thus, the more profit, the more might be the CSR disclosure of the firm.

2.5. Previous Researches and Hypotheses Development

Firms are part of elements establishing the society in social system that results in a reciprocal relationship between firms and the stakeholders (Sayidatina, 2011). This is explained by stakeholder theory stating that one of the responsibilities a firm has toward its stakeholder is by disclosing social information (Dwijayanti et al., 2011). Disclosure on CSR activities is necessary due to the fact that firm “owes a duty to the society or has a social contract” (Karagiorgos, 2010). The central idea is that an organization’s success is dependent on how well it manages the relationships with key groups such as customers, employees, suppliers, communities, financiers, and others that can affect the realization of its purpose. (Freeman and Phillips, 2002).

Corporate disclosures provide a firm an opportunity to spread value information mainly to financial stakeholders as stock analysts, capital markets and institutional investors, and therefore get evaluated on its financial measures (Karagiorgos, 2010). Corporate social responsibility disclosed in the annual reports of firms as the fulfillment of the regulation and public pressures will give additional information to the parties using the reports for their investment decisions. Information is said to be having value added if it results in reactions to do transaction in the stock market. CSR disclosure is expected to give signals and can enhance the firm value in investors’ point of view. It indicates that firms implementing CSR expect to be responded positively by the market that it can maximize its long-term profit (Kelana and Wijaya, 2005; Cheng and Christiawan, 2011). The more the CSR disclosed by the firm, the more investors will be attracted to invest in the firm. The more investors attracted to invest in the firm, the higher the price of the firm's stock because of the higher demand of the stock. The changes in stock price are the result of the market reaction.

There are numerous researches regarding corporate social responsibility. However, despite the prominence of CSR on the global corporate agenda today, it still remains a topic of "hot debate" because of its equivocal impact on bottom line performance. At the center of this debate is "do investors care about CSR?" The popular press is filled with mixed opinions on this issue. On one hand, it seems that mainstream investors do not care about CSR (Yu et al., 2013). As a result, the normative implications of research on corporate social responsibility are still uncertain (Servaes and Tamayo, 2013).

The conflicting results regarding the effect of CSR disclosure to the market reaction exists because of the simple model and the inconsistent measurement (Belkaoui and Karpik, 1989; Sembiring, 2005). Cheng and Christiawan (2011) in their research entitled The Effect of Corporate Social Responsibility to Abnormal Return concluded that investors do consider the CSR for making decision. Hendarto and Purwanto (2012) found that Indonesian firms undertaking voluntary CSR activities gain positive abnormal return when the announcement of mandatory CSR is released. The research conducted by Brammer, Brooks, and Pavelin (2005) about Corporate

Social Performance and Stock Returns: UK Evidence form Disaggregate Measures concluded that firms with higher social performance scores tend to achieve lower returns, while firms with the lowest possible corporate social performance scores of zero considerably outperformed the market.

Since the problem lies in the simple model and inconsistent measurement, this research adds profitability to the observation as moderating variable. The profitability is added in order to have more references to explain the impact of CSR disclosure to the market reaction. When used as moderating variable, Rosiana, Juliarsa and Sari (2013) found that profitability has the ability to strengthen the influence of CSR disclosure to the firm value. On the other side, Wirokosumo (2011) concluded that there is no effect of profitability as moderating variable to the relationship of CSR disclosure and the firm value.

The main reason that profitability is added as moderating variable is that because a firm needs to allocate certain number of funds in order to be able to conduct the CSR activities. To allocate this certain number of funds, the firm must be able to enhance its financial performance. For the firm itself, enhancing financial performance is a must that the stock can attract the investors (Astiari et al., 2014). Thus, the financial performance, which is measured by profitability, is very crucial for the firm's operation as well as its attractiveness to the external parties (investors, creditors, etc.). Profitability implies firm's ability to pay higher dividends, to pay off its debts, and to do its operation in the future which includes doing its CSR activities that has been its obligation. Therefore, firms are striving for more and more profitability.

Based on the legitimacy theory, the profit negatively affects the disclosure of CSR (Donovan and Gibson, 2000; Sembiring, 2005). The reason is that firms with high profit will assume that reporting the information other than the good financial performance of firms is not necessary. In contrast, when the profit is low, the firms will expect that the user of the report will obtain the "good news" of the firms' performance. The lower profit is not attractive to the investors that causes decreasing demand of the stock, thus the stock price will decline. This is proven in a research conducted by Saraswati and Basuki (2012) in Astiari et al. (2014) showing that firms with broader CSR disclosure tend to have lower stock price.

On the other hand, the higher profit will enable the firm to do more CSR activities that eventually will be reported in its annual report. This is supported by the statement of Maskun (2013) saying that profitability is a factor that enables management to freely and flexibly disclose the social responsibility to the shareholders. The argument is aligned with the agency theory stating that the more the profit of a firm the broader is the disclosure of the social information (Sembiring, 2005). Firms with higher profitability will then have the ability to disclose more CSR information that is expected to be responded positively by the investors through the change in the stock price.

The more profitable a firm becomes, the more the tendency of the firm to focus too much on striving for profitability that the environment and society are more likely to be abandoned. However, if the environment and society are abandoned, it will cause legal issues to the firms to the certain extent that will hinder firm's operational activities that would cause bad image to the investors' point of view. Therefore, firms would give more concern in disclosing their CSR to give good signal to the investors in their decision making process.

Since doing the CSR activities would need cost, the firms with high profitability are then more capable to disclose more CSR activities. similarly, the ones that have lower profitability will as well have lower ability to disclose their CSR activities because of the lower funds allocated to the activities. The information of CSR activities disclosed in firms' annual report will eventually be used by the investors in making their investment decision. This means that profitability has an impact in disclosing the CSR disclosure to facilitate the needs of investors to make their investment decision. Therefore, profitability has the capacity to positively impact the relationship between CSR disclosure and the market reaction. Considering this, the hypothesis is developed as follows:

H1: Profitability positively impacts the relationship of CSR and market reaction