CHAPTER II

CORPORATE SOCIAL RESPONSIBILITY AND HYPOTHESIS DEVELOPMENT

2.1 Corporate Social Responsibility

Corporate social responsibility is becoming an increasingly important issue for economic agents due to a new attention to all the aspects of firms' activities and their relationship with stakeholders. The definition of corporate social responsibility is not abstruse. Darwin in Titisari (2010) gives definition of corporate social responsibility as: a company's commitment to operating in an economically, socially and environmentally sustainable manner whilst balancing the interests of diverse stakeholders, which implement further than the law of corporate social responsibility. McWilliams & Siegel (2001) describe corporate social responsibility as "actions that appear to further some social good, beyond the interest of the firm and that which is required by law."

Even if there is wide variety of corporate social responsibility definition, a point worth noticing is that corporate social responsibility is more than just following the law. A socially responsible corporation should take a step forward and adopt policies and business practices that go beyond the minimum legal requirements and contribute to the welfare of its key stakeholders. Companies with poor social performance record may increasingly find it difficult to obtain the necessary resource and support to continue operations within the community,which risked the company long-term sustainability.

Titisari (2010) stated that other point of corporate social responsibility definition, that is worth noticing is that corporate social responsibility can not be separated from shareholder and stakeholder welfare, which included: company’s owner, employees, community, government, and environment. This concept then translated by John Elkington into triple bottom line, which is profit, people, and planet. It implies that the objective of corporate social responsibility should be able to increase company’s profit, increase employees and communities welfare, as well as increase the quality of environment.

The implementations of corporate social responsibility are even more differ from one company to another one. The differences depend on such factors as the specific company’s size, the particular industry involved, the firm’s business culture, stakeholder demands, and how historically progressive the company is in engaging corporate social responsibility. Some companies focus on a single area, which is regarded as the most important for them or where they have the highest impact or vulnerability—human rights, for example, or the environment—while others aim to integrate corporate social responsibility in all aspects of their operations.

2.2 Disclosure of Corporate Social Responsibility

2.2.1 Definition of Disclosure

Conceptually, the disclosure is an integral part of financial reporting. Technically, the disclosure is last step of the accounting process in the presentation of information in the full set of financial statements form. Evans (2003) in Suwardjono (2008) defines disclosure as follows:

> "Disclosure means supplying information in the financial statements 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."

Disclosure is often also interpret as providing more information than what can be delivered in the form of formal financial statements. This seems consistent with the idea of the FASB in its conceptual framework as follows (SFAC No.. 1, paragraph 5):

> "Although financial reporting and financial statements have essentially the same objectives, 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."

2.2.2 Function and Purpose of Disclosure

Disclosure of financial information is aimed to satisfy parties that have, or pottentially have an economic or financial interest in the companies. As FASB states, these potential users of financial reports and their information needs can include equity investors, creditors, suppliers, employees, customer, governments and their agencies and regulatory bodies, also member of the public.

These potential users will be affected on information that company disclose, as Suwardono (2008) stated disclosure genereal objective is to provide information which seen needed to aim the objective of financial reporting and to serve many potential users that have different interests.

Disclosure of corporate social responsibilty, as Anna Booth stated in Deegan (2000) has clear objective and will give ultimate beneficiaries of corporate growth, and other important stakeholders could include employees, customers, welfare groups, the local community, and the government. Companies that neglected this in favor of a narrow focus on shareholder returns risked limiting their long term financial performance.

2.2.3 Intended Users of Disclosure

To quote the FASB:

> "Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and simmillar decissions."

The desicisions to be made my investors and creditors are relatively straightforward and well defined: investors primarily make buy-sell-hold decisions, and the decisions of creditors are primarily related to the extension of credit to the enterprise. Stockholders, ands sometimes creditors, may also make decisions regarding the hiring, firing, and compensation of management and the approval or dissaproval of major changes in firm policy (Hendriksen et al, 1992).

Generally the disclosure objective made by company is to satisfy different stakeholders which include investor, creditors, government, community, and other parties that may related. Therefore, disclosure required more than financial reporting alone, but also the disclosure of quantitative and qualitative information (Suwardjono, 2008).

2.2.4 Level of Disclosure

Level of disclosure is related to how much information should be disclosed. The FASB, for instance, has held that information being disclosed in financial report 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."

In the book of Accounting Theory, Hendriksen and Breda (1992) identify three types of disclosure level, which include:

- Adequate Disclosure

  Adequate disclosure implies a minimum amount of disclosure congrous with the objective of making the statements not misleading.

- Fair Disclosure

  Fair disclosures implies an ethical objective in same and equal manner to all reporting users by providing equal treatment for all potential readers.

- Full Disclosure

  Full disclosure implies the presentation of all relevant information. Full disclosure supplies the users of financial statement with significant and relevant information to aid them in making decisions in the best possible way with the limitation that the benefits should exceed the costs. This implies that information that is not material or relevant is omitted to make the presentations meaningful and understandable.

2.2.5 Type of Dicslosure

Type of Disclosure that implemented by company are categories into two: voluntary disclosure and mandatory disclosure. Voluntary disclosure is disclosure that implemented by company, beyond what is required by accounting standard or legislation. Conversely, mandatory disclosure is disclosure that implemented due to the regulations or accounting standards.

Hendriksen and Breda (1992) stated company will disclose all the information that is necessary for the optimal functioning of capital market, especially if the information is good news. Company also eager to dislose information that able to increase its credibility and sustainability, even if the information is not required to be disclosed.

2.2.6 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 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.

2.2.7 Disclosure of Corporate Social Responsibility

Information that disclose, is not merely financial performance, but also social performace, which often called social disclosure, corporate social reporting, social accounting. In the book of Australian Financial Accounting (2000), Deegan defined social responsibility reporting as:

"the provision of information about the performance of an organisation with regard to its interaction with its physical and social environment". Moreover, Deegan include several factors as an organisation's: interaction with local community; level of support for community projects; developing countries; health and safety record; training, employment and education programs; environmental performances.

These disclosures are typically made within a company's annual report, and generally within the Directors' Report or its equivalent. Historically, Wibisono (2007) revealed development of corporate social responsibility reporting through stages as follows:

Table 2.1

Development of Corporate Social Responsibility Reporting

NO	REPORTING TYPE	PERIODE
1	Financial Accounting & Reporting	Around 1850
2	Financial Aspects of Corporate Governance	Beginning of 1990
3	Environmental Reporting	Beginning of 1990
4	Social Accounting & Reporting	Beginning of 1990
5	SustainableReporting (reporting on environmental, social and wider economic impact)	Since 2000

Source: Wibisono (2007)

Though social performance reporting is quite unregulated, unlike financial performance reporting. Nevertheless, companies need to be accountable for their social performance, just as they are for their financial performance. Failure of demonstrating accountability in relation to key aspects of expected social performance will inevitably have negative implications for the ongoing operations of a company. The term ‘accountability’ as adopting the definition provided by Gray, Owen, and Adams in Deegan (2000):

“The duty to provide an account (by no means necessarily a financial account) or reckoning of those actions for which one is held responsible.”

Accountability involves two responsibilities; the responsibility to undertake certain actions (or refrain from taking actions); and the responsibility to provide an account of those actions. In wide extend of corporate social responsibility, accountant should be able to demonstrate accountability in the areas of performance in which the community has the greatest interest.

The unexisting requirement by legistation or Accounting Standards regarding corporate social responsibilty, make it harder to measure. As included in Australian Accounting Theory (2000) book, accountability of corporate social responsibility only provide an overall framework that corporate social responsibility could indirectly affect the financial results of a firm, increasing firms’ reliability, decreasing risk and improving relationships with stakeholders. Thus, corporate social responsibility could also be a driver of value creation.

2.3 Stock Return

Motivation of investors to invest is the hope to obtain an appropriate return. Without the return, of course, the investors would not be willing to invest. So, in this case the main purpose of a person's conduct is to obtain the return of investment, both directly and indirectly. Therefore, we can conclude that expected return is the return for investors will be gained on the investment made in a company.

Factors affecting the return on an investment include the first, the company's internal factors such as quality and reputation management, capital structure, the structure of corporate debt, and so on. The second factor is related to external factors, such as the influence of monetary and fiscal policy, the development of industrial sector, and so on (Ang, 1997)

According to Abdul Halim (2005), components of return (return) include:

1. Profit / Loss of capital (capital gain / loss) is the profit (loss) for investors earned in excess of the selling price (purchase price) above the purchase price (selling price) which both occur in the secondary market.

2. Yield (yield) is an income or cash flow received by investors periodically, for example in the form of dividends or interest. Yield expressed as a percentage of capital invested.

Return is the cornerstone in determining investment. Assessment of returns received should be analyzed, among others, through the analysis of returns received in the previous period (returnhistorically). Based on the results of the analysis is then used to analyze the expected return (expected return). Expected return is the expected rate of return on investment an investor on an investment that will be received in the future.

Return of an investment depends on its investment instruments, like stocks. Stock does not promise a certain return for investors. However, some components of return on stocks that enableinvestors to benefit are the dividends, bonus shares and capital gains (Ang, 1997).

According Suratno et al. (2006) stock return can be interpreted as the achievements that have been realized through the work that has been done and set forth in the financial statements and can become a benchmark for ascertain the level of success of the company within a certain period. Enhancement financial performance can increase firm value.

In addition to the conceptual framework of corporate social responsibility, many studies have been focused on the Corporate Social Performance measurement in order to link corporate social responsibility investments and activities to firms financial performance. Empirical studies on corporate social performance have provided interesting findings that suggest the possible way to measure different dimensions of firm performance related to corporate social investments. Result consists of three principal strands; the existence of a positive correlation between corporate social responsibility to financial results; the lack of correlation between corporate social responsibility to financial results; and the existence of a negative correlation between corporate social responsibility to financial results.

Study found that the different result could be attributed to the wide array of measures that have been used in empirical studies on corporate social responsibility and the variety of firm performance's definitions proposed in the literature. According to Waddock and Graves in Fiori (2007) it is possible that better performance along various dimensions of corporate social performance leads to better financial results. While on the other hand, according to the slack resource theory, financially successful companies have more resources to spend on corporate social performance and therefore they will attain a higher standard.

Numerous previous researchers have been studied the relation of information disclosed in annual report to financial performance, including: return on asset, return on equity, profitability, stock prices, and return. The objective is to give empirical evidence of how far financial information and non financial information in the annual report affect to financial performance indicators.

In general, measurement of financial performance can be calculated according to accounting-based and capital market-based measures. Accounting-based measures use financial ratio analysis as a measurement financially. While market-based capital can be measured using the stock return. Empirical studies of the relationship between corporate social responsibility and financial performance ever experienced on both. The first uses the event study methodology to assess the short-run financial impact (abnormal returns) when firms engage in either socially responsible or irresponsible acts. This is done by Titisari (2010) who investigated relation of corporate social responsibility to cumulative abnormal return.

The second type of study examines the relationship between some measure of corporate social performance (CSP) and measures of long term financial performance, by using accounting or financial measures of profitability. Both first and second types of study that explore the relationship between social responsibility and financial performance using two measures have also produced mixed results. This is done by previous researchers who studied corporate social responsibility information, namely Brammer (2005) who investigated relation of corporate social responsibility to stock return, and Fiori (2007) who investigated relation of corporate social responsibility as non financial information to stock prices.

Therefore, this study uses market-based measures, and also takes into consideration other controlling variables which can have an effect on stock prices (express in financial ratio as an approach to accounting-based measures) in order to produce more comprehensive result.

2.4 Theoretical Frameworks of Corporate Social Responsibility

2.4.1 Legitimacy Theory

Researcher who study corporate social responsibility and its disclosure have embraced Legitimacy Theory and Stakeholder Theory. Both theories used to highlight the role of information and disclosure in the relationship between company, government, individuals, and community. Within the Legitimacy Theory, the company sees as part of a wider social system in which the company's continued operations and success are dependent upon it complying with the expectations of the society in which it operates (Deegan, 2000).

Legitimacy theory implies that companies may only continue to exist if the society in which they operate perceives those organisations to be operating to a value system consistent with the society's own; which means that companies have to consider the rights of public in broader image, not merely their investors. Act No. 40 year 2007 enacted by government reflects the view of the government's consituency, increases coporate social responsibility legistation that may consider as an indication of increased community concern about the state of the company social performances.

As the community expectations changing, new regulations issued, and emerging scientific knowledge about the impacts of human activities over the time, company should also adapt and change. Public disclosure of information is one strategy that an organisation can undertake to establish and maintain its adaption as well as state of its legitimacy. The disclosure policies of the companies are often affecting by the expectations of the various groups. Various groups can be explained by Stakeholder Theory.

2.4.2 Stakeholder Theory

Stakeholder Theory consider companies as part of the wider social system and different stakeholder groups. According to Deegan (2000), various social responsibility activities undertaken by company, including public reporting, will be directly related to the expectations of particular stakeholder groups. Company will have an incentive to disclose information about their programs to indicate clearly that they are conforming with the expectations from stakeholders. Further, Deegan explains that Stakeholder Theory implies that all stakeholders have the right-to-know about compay’s operation and information, how it affects them, even if they choose not to use the information. Social disclosure could be a vehichle for company to provide information about company social performace that finally able to fulfill the needs of all interested parties.

2.5 Hypothesis Development and Previous Research

Research about corporate social responsibility have been done by many researchers in different countries and period. Generaly those researches have company charateristic that predicted to have relation and affect in disclosure of corporate social responsibility information in the annual report, which become essential tool for stakeholder in term of decision making and valuing company performance. Several researchers who study relation of corporate social responsibility to financial perfomance are presented in the table below:

Table 2.2

Result of Previous Research

No	Researcher (Year)	Variable	Statistical Method	Result
1	Zuhroh and Sukmawati (2003)	Variables dependent: volume trade of the stock Variable independent: corporate social responsibility	Analysis linear regression	Disclosure in social report annual company influential against volume trade the stock.

2	Brammer et al (2005)	Variable dependent: stock return Variable independent: CSR environment, CSR employment, CSR community	Analysis linear regression multiple	Corporate social responsibility focus on environment and employment affects negatively to return, whereas community affects positively.
3	Fiori et al (2007)	Variable dependent: stock price Variable independent: CSR environment, CSR employment, CSR community	Analysis linear regression multiple	Corporate social responsibility focus on employees affects positively and significantly to market prices of stock. While community and environment affect not significantly negative to stock prices.
4	Sayekti et al (2007)	Variables dependent: Cumulative Abnormal Returns variable Independent: Unexpected earnings and disclosure information of corporate social responsibility	Analysis linear regression	Multiple level disclosure corporate social responsibility information in the company annual report annual shows negative impact on Earnings Response Coefficient.

5	Titisari et al (2010)	Variable dependent: return of stock with Cumulative Abnormal Return. Variable independent: CSR environment, CSR employment, CSR community	Analysis linear regression multiple	Variables environment and community affect not siginifanctly positive with Cumulative Abnormal Return, whereas parameter employment precisely correlated negatively.

<u>**Hypothesis Development**</u>

The availability of disaggregate data on various aspects of CSR performance is likely to be important since CSR is multi-faceted these various aspects may have differential impacts depending on the nature of the firm’s business. Socially responsible corporate performance can be associated with a series of bottom-line benefits. But in many cases, it seems that the time frame of the costs and benefits can be out of alignment—the costs are immediate, and the benefits are not often realized quarterly. For example on the employee relations side, it is possible that practices such as flexible scheduling to allow workers to achieve desirable work-life balances may enhance productivity, reduce absenteeism, and may make it easier to recruit and retain high caliber staff (Brooks et al, 2005).

Anggraini (2006) found that company banking and insurance largely (more than 50%) disclose information about the development its human resources as compared with other industries. This is because the industry is highly dependent on the ability of human (employees) in providing services to the customer.

Recent research suggests that three-fourths of workforce entrants in the US regard social responsibility and environmental commitment as important criteria in selecting employers (p. 10 “Why Sustainability is Now the Key Driver in Innovation”, Harvard Business Review, September 2009.) Company that take good care of their employee issue will be able to increase productivity and improve employees’ morale, as well as enhancing company to cost savings and and produced more income. Therefore good disclosure of corporate social responsibility (of employees issues in this case) are perceived as something valuable to the sustainability of the companies.

According to Tsoutsoura (2004) companies that improve working conditions and labor practices also experience increased productivity and reduced error rates. Regular controls in the production facilities throughout the world ensure that all the employees work under good conditions and earn living wages. These practices are costly, but the increased productivity of the workers and improved quality of the products generate positive cash flows that cover the associated costs. Thus, firms may actually benefit from socially responsible actions in terms of employee morale and productivity.

A higher focus on employees and CSR practices related to them is well perceived by the investors and has a positive effect on stock price. This is supported by Fiori et al (2007) that stated that the market perceives corporate social responsibility in employee issues as a good investment, rather than a cost, which consequently lead to a positive effect on stock price. Shareholders believe that employees are valuable resources and all corporeate social responsibiility practices implemented for them will give a positive impact on short-term and long-term profitability.

Various arguments about advantages to corporate social responsibility also followed by contra arguments who consider corporate social responsibility as cost added. Corporate social responsibility perceived as something really expensive by the investors who historically more focused on the profit maximization for shareholders. Therefore, balancing the financial expectations of company owners with the environmental requirements of other stakeholder groups, does not seem work for investors.

This is evidence by Fiori et all (2007) states that the market has a bad perception of corporate social responsibilty that focus on environemt practices because they are expensive. In fact, the companies have to spend money and resources in order to implement environmental management accounting and to make them work and to establish stable relationships with government which could have positive effects in the long term. But the investors, usually showing a short term view, perceive them as a cost more than a benefit, generating a reduction of short-term profitability of the company.

Those finding are different to Zieger (2009) whom stated that a good reputation due to corporate environmental activities such as certification of environmental management according to ISO 14001 as an element of CSR is a further example for an intangible resource. This could particularly lead to higher sales among customers who are sensitive to such issues and therefore to increased corporate profits or corporate financial performance. In this respect, new technologies which are installed due to proactive corporate environmental activities are an example for a tangible or physical resource if these technologies can be capitalized and not easily imitated by competitors.

Aside from corporate social responsibility in employees and environment issues, community issues has been acknowlegded too. According to Ismail (2009) community is generally defined as a group of people sharing a common purpose, who are interdependent for the fulfillment of certain needs. There are shared expectations for all members of the group and responsibility taken from those expectations, where company has a strong role in those development. Closer ties between corporations and community and the social system can be formed in company social responsibility in communities, which lead beyond the perception that corporation is a place just to get employed and producers of goods and services. By implementing social responsibility to community, corporations and community would stay in peace and harmony. This becomes a social capital that is essential in community development.

Study from Derwall et al. (2004) in Brammer (2005) who focus on the society aspect of corporate social responsibility, suggest that firms who are able to improve their community performance can reduce their CAPM betas and raise their stock prices by up to 5%.

In this study, the sign of the relationship between corporate social responsibility and financial performance is tested. The sign may imply negative, neutral or positive linkages. The neutral linkages resulted from many variables that intervene between the corporate social responsibility and corporate financial performance that a relationship should not be expected to exist. The argument for a negative relationship follows the thinking that socially responsible firms have a competitive disadvantage (Tsoutsoura, 2004), because they incur costs that fall directly upon the bottom line and reduce profits, while these costs could be avoided or borne by individuals or the government.

The positive linkage proposed that the actual costs of CSR are covered by the benefits. A firm that attempts to decrease its implicit costs by socially irresponsible behavior—by, for example, neglecting to take measures against pollution—will eventually incur higher explicit costs. Socially responsible companies have less risk of negative events. It is less likely for these companies to pay heavy fines for excessive polluting, to have costly lawsuits against them, or to experience socially negative events that would be destructive to their reputation.

Therefore, from the discussion above and refer to previous researcher, this study formulate following hyphothesis:

Ha: The disclosure about corporate social responsibility affect the stock prices.