

Study of The Determinants Existence of External Assurance on Sustainability Reports in Indonesia

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Keywords: External Assurance, Firm Size, Industry Affiliation, Profitability, Sustainability of Department, Sustainability Reports.

Abstract: Due to the growing trend of firms publishing stand-alone sustainability reports, adhering to an unprecedented demand for disclosure, sustainability reports are now equally as important as financial reports. Following this occurrence, subjective and partial disclosures with external assurance are required to assure and maintain credibility of information within sustainability reports. Thus, the purpose of this research is to obtain empirical evidence related to the determinants that affect the existence of external assurance on sustainability reports in Indonesia. The sample being tested are 116 companies registered in the Indonesia Stock Exchange (IDX) during the period 2013–2015, which are issuing stand-alone sustainability reports. The logistic regression model is employed within hypothesis testing. The result showed that both Profitability and Industry Affiliation positively and significantly affect the Existence of External Assurance on Sustainability Reports, meanwhile, Firm Size had positive influence but not significant. Sustainability Department was also found to be an insignificant determinant to the Existence of External Assurance on Sustainability Reports.

1 INTRODUCTION

In a modern context, the goal of corporations is to extend not only to generate profits, but also as a frontier to incarnate social welfare. To support the realization of social welfare and cope with ever-changing social and environmental problems, corporations should contribute and undertake sustainable activities, which at the organizational level, are reflected through the inclusion of economic, environmental, and social aspects of companies' activities as performance indicators to generate long-term shareholder value (Çalışkan, 2014). Nevertheless, it is difficult to properly assess the social and environmental performance of companies because firms lean on financial figures that are endowed with a limited ability to reflect on the activities of contemporary business models and their consequences (Banerjee, 2002; Jones, 2010).

Over the past two decades, companies have paid more attention to their efforts in recognizing and measuring environmental issues in financial reporting, as more stakeholders have voiced further concerns regarding this issue (Bobe & Dragomir, 2011). Consequently, this has prompted the

inclusion of corporate social responsibility information in the annual reports from many corporations. Environmental and social information could be disclosed as part of a company's published annual reports. Furthermore, this information could be disclosed separately within a stand-alone sustainability report.

The issuance of stand-alone corporate social responsibility (CSR) reports has shown a dramatic growth over the past two decades. KPMG International surveyed 4,100 companies worldwide in 2013 and found that 71% of those companies are engaged in CSR reporting (KPMG International, 2013). However, Cho, et al. (2012) stated that such practice of voluntary corporate disclosure is subject to concerns regarding the completeness and credibility of the information that is being provided. One way to handle the issue of credibility is by obtaining third-party assurance (Simnett, et al., 2009). International evidence has proven the existence of a growing number of corporations using third-party assurance for their CSR report. In 2011, only 45% of the Global 250 corporations published CSR reports with a third-party assurance and this had grown to over half by 2013 (KPMG

International, 2013). There are no formal regulations to ensure that companies report their non-financial information separately, so there is no mandate to include assurance statements within their stand-alone CSR reports (Simnett, et al., 2009).

Simnett, et al. (2009) identified several findings in their research, in which they had examined a sample of 2,113 companies across 31 countries that produced sustainability reports during the period 2002–2004. They hypothesized that the decision to assure stand-alone sustainability reports is a function of company, industry-, and country-related factors. In contrast to the research by Simnett et al. (2009), Cho et al. (2014) focused only on firm-related factors in his research, carried out in the USA due to the country's shareholder-oriented characteristics, which can inhibit the effect of such country-related factors to drive the demand of sustainability assurance.

Understanding the need to provide external assurance for information disclosed within sustainability reports, this study proposes four variables, namely profitability, size of the firm, industry affiliation, and the sustainability of the department, as determinants of external assurance in sustainability reports. The research revolves around the effect of these four proposed determinants towards external assurance in the reporting of sustainability.

2 LITERATURE REVIEW

2.1 Theoretical Basis

2.1.1 Legitimacy Theory

Legitimacy is defined as “a generalized perception or assumption that the action of an entity is desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions” (Suchman, 1995, p.574). Deegan (2002) considered sustainability reporting as a tool for the communication of the corporation and society. Sustainability reporting is used by corporations to justify sustainable activities held by them and to clarify any incidents that might possibly have a detrimental effect on their reputations. Furthermore, Simnett et al. (2009) proposed that corporations' decisions to provide assurance on their reports are driven by their desire to improve the credibility of the disclosed information, and this is in line with companies' objectives to gain legitimacy.

2.1.2 Stakeholder Theory

The stakeholder approach explains the complex relationships that occur between organizations and their stakeholders, which are based on the responsibility and accountability of organizations (Gray et al. 1996). Liesen et al. (2015) stated that stakeholders can have contrasting concerns toward companies' social and environmental responsibilities and that sustainability activity can be an effective method for companies to address these concerns. They also concluded that sustainability disclosures and assurance can be one way to reduce stakeholder pressure and the threat of legitimacy (Liesen et al., 2015).

2.2 Hypothesis Development

2.2.1 The Influence of Profitability on the Existence of External Assurance in Sustainability Reports

Profitability is closely tied with profit, yet it refers to the relative value of a firm's ability to generate return on investment based on employed resources in comparison to alternative investment. The relationship between corporate profitability and social and environmental disclosure is rather inconclusive. Some argue that profitable firms have more social constraints and public exposure, so they must ensure that their profit has not been gained at the expense of society through the use of sustainability reports (Gamerschlag et al., 2010). On the other hand, Neu et al. (1998) argue that unprofitable firms are more likely to disclose social information, either to support their poor financial performance or to guarantee their long-term competitive advantages caused by current environmental investments. Branco et al. (2014) and Kend (2015) found that profitability has significantly affected the company's demand to adopt assurance on their sustainability reports. Based on the preceding explanation, the hypothesis can be proposed as follows:

H1: Profitability significantly influences the existence of external assurance on sustainability reports

2.2.2 The Influence of Firm Size on the Existence of External Assurance on Sustainability Reports

Dang and Li (2015) define firm size as a measure of total assets, sales, and market value of equity within

their natural value. In general, large companies face a greater political risk than small firms. Large companies experience more pressure from the public to carry out social responsibility. Therefore, large companies will be more inclined to assure their sustainability reports, to increase public confidence and reduce the possibility of detrimental claims from society regarding the company. In addition, large companies have excess resources to undertake sustainability assurance that is still voluntary. For example, research conducted by Simnett et al. (2009) and Branco et al. (2014) have determined firm size as a firm-level variable that was proven to have a significant influence on the company’s demand of sustainability assurance. Based on the preceding explanation, the hypothesis can be proposed as follows:

H2: Firm size significantly influences the existence of external assurance on sustainability reports

2.2.3 The Influence of Industry Affiliation on the Existence of External Assurance on Sustainability Reports

This study defines industry affiliation as a classification of firms in accordance to their respective business operations, belonging to a specific industry. Many previous studies have shown a relationship between industry classifications and a firm decision to assure their sustainability reports. Simnett et al. (2009) and Cho et al. (2014) in their research have found similar evidence that utilities, mining, and finance industries are more likely to have their sustainability reports assured. However, Cho et al. (2014) grouped several “more sensitive” industries into a separate classification, namely an environmentally sensitive industry (ESI) variable. Based on the preceding explanation, then the hypothesis can be proposed as follows:

H3: Industry affiliation significantly influences the existence of external assurance on sustainability reports

2.2.4 The Influence of the Existence of the Sustainability Department on the Existence of External Assurance on Sustainability Reports

A sustainability department is one which focuses primarily on ensuring a firm has the ability to achieve a profitability objective, while also ensuring

that society outreach is not neglected. It represents a more effective integration of sustainability matters, which can be the driver for an advanced sustainability reporting system and continuous improvement on the level of credibility of this environmental and social information (Kend, 2015; Gillet & Martinez, 2011). Ruhnke and Gabriel (2013) have evidenced a strong and positive correlation between the existence of a sustainability department with the decision to assure sustainability reports. Hence, it is predicted that those companies that release stand-alone sustainability reports and have voluntary assurance statements accompanying those reports, will be more likely to have separate sustainability departments, as a reflection of their strong commitments regarding social and environmental issues. Based on the preceding explanation, the hypothesis can be proposed as follows:

H4: A sustainability department significantly influences the existence of external assurance on sustainability reports

3 RESEARCH METHODOLOGY

3.1 Conceptual Framework

The following conceptual framework is used in this study to describe the relationship between independent variables of profitability, firm size, industry affiliation, and the sustainability of a department and external assurance on sustainable reports.

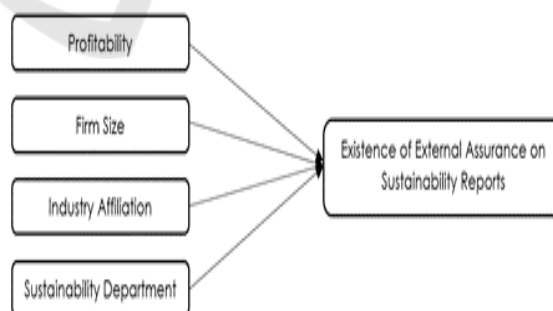


Figure 1: Conceptual framework.

3.2 Operational Definition and Measurement of Variables

3.2.1 Existence of External Assurance on Sustainability Reports

The existence of external assurance on sustainability reports is measured by using a dummy variable, in which it takes the value of 1 in the case of the presence of an assurance statement in a company’s stand-alone sustainability report and the value of 0 when such statement does not exist.

3.2.2 Profitability

This research will use the ROA ratio as the benchmark for a firm’s profitability, as it has been used extensively in much previous research (Folk and Per ego, 2010; Haida et al., 2013; Ruhnke & Gabriel, 2013) as the proxy for profitability. Prior research (Ruhnke & Gabriel, 2013; Cho et al., 2014) used earnings before interest and tax to account for the return, which is the numerator in the ROA computation, because earnings before interest and tax (EBIT) is perceived to be as an effective proxy for the actual return resulting from the investment in company.

$$ROA = \frac{Earning\ before\ Interest\ and\ Taxes\ (EBIT)}{Total\ Assets} \times 100\%$$

(1)

3.2.3 Firm Size

Firm size in this research is obtained using a firm’s total assets. Therefore, a natural log of the firm’s total assets is computed to yield a firm size figure.

$$Firm\ size = Ln\ (Assets)$$

3.2.4 Industry Affiliation

This dummy variable will give the value of 1 if a company is a member of an industry that is classified as having significant social and environmental impact and the value of 0 for companies not included in that classification. This research classifies ESI (Environmentally Sensitive Industries) that consists of mining and extraction, paper, chemicals, petroleum, metals, utilities (Batten, 2002), finance (Simnett et al., 2009), and technology and telecommunication (Zorio et al., 2013), as industries with a considerable impact on society and the environment. All industry classifications will be based on the GICS (Global Industry Classification Standard) code.

3.2.5 Sustainability Department.

Following what has been applied in research by Ruhnke and Gabriel (2013), sustainability department in this research, can be referred to as sustainability department, CSR committee, and

environmental and social department. Thus, if a company has one of these three functions, then it’s sustainability department variable would be scored as 1.

3.3 Research Model

In line with the preceding explanation, thus, the model of analysis for this research is as follows:

$$Assurance_i = \ln \frac{\pi_i}{1-\pi_i} = \beta_0 + \beta_1 Profit_i + \beta_2 S_i + \beta_3 Ind_i + \beta_4 SDept_i + \epsilon$$

(2)

Where, for company i:

- $Assurance_i$ (0, 1) = Dependent variable (Existence of external assurance on sustainability reports)
- π_i = Probability value of Existence of external assurance on sustainability reports.
- β_0 = Constant
- β_{1-10} = Coefficient
- $Profit_i$ = Profitability, as measured by the ROA ratio.
- S_i = Firm size, as measured by Ln (assets)
- Ind_i (0, 1) = Industry affiliation (whether included in a category of either industry, with or without significant social and environmental impact)
- $SDept_i$ (0, 1) = The existence of sustainability department in a firm

4 RESULTS AND DISCUSSION

4.1 Hypothesis Testing Result

Table 1: Logistic regression result.

Variable	B	Wald	Sig.	Exp (B)
Profitability	7.821	8.512	0.004	2492.111
Firm Size	-0.024	0.014	0.905	0.976
Industry Affiliation	3.373	11.958	0.001	29.177

Sustainability Department	0.869	2.701	0.100	2.386
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Accordingly, the regression equation that can be created based on the table above is:

$$Assurance_i = \ln \frac{\pi_i}{1 - \pi_i} = -4.269 + 7.821 Profit_i - 0.024 S_i + 3.373 Ind_i - 0.869 SDept_i + \varepsilon \quad (3)$$

4.1.1 The Influence of Profitability on the Existence of External Assurance on Sustainability Reports

The result shows that the coefficient value for Profitability is positive with a significance level of 0.004 ($p < 0.05$). Therefore, there is a significant and positive relationship that exists between profitability and the existence of external assurance on sustainability reports. This result is consistent with research by Ruhnke and Gabriel (2013) and Branco et al. (2014). According to Ruhnke and Gabriel (2013), firms with a higher profitability have higher financial capacity and face less pressure from equity investors. This provides an incentive for companies to improve their credibility in terms of sustainability reporting, so that they can report and demonstrate their high sustainability performance.

4.1.2 The Influence of Firm Size on the Existence of External Assurance on Sustainability Reports

The result of the hypothesis testing demonstrates that the coefficient value for firm size is negative with a significance level of 0.905 ($p > 0.05$). Therefore, firm size has an insignificant negative effect on the existence of external assurance on sustainability reports. The results in this study are consistent with research conducted by Cho et al. (2014), as they concluded that the economic and legal environments of specific countries become contributing factors of sustainability assurance decisions.

4.1.3 The Influence of Industry Affiliation on the Existence of External Assurance on Sustainability Reports

The result shows that the coefficient value for Industry Affiliation is positive with a significance level of 0.001 ($p < 0.05$). Therefore, industry affiliation significantly and positively affects the existence of external assurance on sustainability

reports. This result is in line with research conducted by Cho et al. (2014) and Branco et al. (2014).

4.1.4 The Influence of a Sustainability Department on the Existence of External Assurance on Sustainability Reports

The result of hypothesis testing shows that the coefficient value for a sustainability department is positive with a significance level of 0.100 ($p > 0.05$). Therefore, there is an insignificant and positive relationship that exists between a sustainability department and the existence of external assurance on sustainability reports. Prior research has produced conflicting results regarding the influence of sustainability department on sustainability assurance. Research by Ruhnke and Gabriel (2013) is contrary to this research, as well as research conducted by Kend (2015). There is an allegation that this sustainability department just acts as a symbol to signal the company's attention toward sustainability. Moreover, the rare existence of sustainability departments in Indonesia does not guarantee a company's performance in the context of sustainability, including the decision about whether to assure its sustainability report, as such decisions can be made immediately by senior managers.

5 CONCLUSIONS

Based on the above discussion, the following conclusions can be made: First, profitability, as the first determinant in hypothesis testing, indicates a positive and significant effect on the existence of external assurance on sustainability reports. It implies that firms in which business operates profitably or have higher financial capacity are more likely to provide external assurance through sustainable reports to ensure that profit does not come at the expense of social welfare. Moreover, firm size, the second determinant, is proven to have a negative and insignificant effect on the existence of external assurance on sustainability reports. It asserts that engagement towards external assurance of a sustainable report is not contingent to its size. Furthermore, variables of industry affiliation had positive and significant effects on the existence of external assurance on sustainability reports. It emphasizes that industry affiliation plays a significant and important role in driving managerial

decisions to provide sustainable reports. Lastly, results suggested that the sustainability department had a positive but not significant effect on the existence of external assurance on sustainability reports. A sustainability department drives a firm's policy to meet its profit objectives, develop social outreach, and encourage firms to engage in external assurance of sustainability reporting.

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