

CSR Reporting Practices, CSR Disclosure, and the Cost of Equity Capital

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Abstract: The trend regarding the adoption of corporate social reporting (CSR) not only applies to developed countries but also to developing countries. In developing countries, there has been an increase in both CSR disclosure and the quality of CSR reporting. The aim of this paper is to investigate the use of CSR reporting practices in relation to whether they provide greater disclosure of CSR, in addition to determining the effect of CSR disclosure on the cost of equity capital. CSR practices utilize standalone CSR reports, the Global Reporting Initiative (GRI) framework, and CSR information assurance. Several criteria were used for the research sample: (1) manufacturing companies listed on the Indonesian Stock Exchange between 2013 and 2015; (2) companies had published annual reports or sustainability reports; and (3) data for the variables used was available. The data analysis technique utilized in this research was PLS regression, using WarpPLs. The results show that companies using CSR reporting practices (i.e. standalone reports and GRI adoption) disclose broader CSR information, and companies that provide an assurance of CSR information do not disclose sufficient CSR information. Further, CSR disclosure affects the cost of equity capital in that there is a negative relationship between CSR disclosure and the cost of equity capital.

1 INTRODUCTION

Previously, businesses only paid attention to profits; however, businesses have changed this perception by also paying attention to people and the planet. This has happened in companies throughout the world, which can be seen from a survey conducted by KPMG in 2015. In this sense, corporate social reporting (CSR), especially in the Asia Pacific region, has increased significantly, with the increase driven by a surge in reporting in countries such as India, Taiwan, and South Korea. In addition, the quality of CSR has also experienced an increase in the Asia Pacific region. In this regard, the concept of CSR is not limited to developed countries but is also being increasingly adopted in developing countries.

CSR activities undertaken by a company are sometimes focused on those directly related to the activities of the company and sometimes on those not directly related to the activities of the company. CSR activities usually come in the form of donations to community activities, donations to victims of natural disasters, and donations to prevent environmental damage caused by corporate activities, amongst others.

Under Indonesian law, a CSR report should be disclosed in the company's annual report. However, in the regulations, there is no obligation for the entity to disclose a standalone report with regards to sustainability or CSR. Thus, in Indonesia, such disclosures are still voluntary. If the entity discloses a standalone report, this will accrue more costs. Francis et al. (2005) found that firms in industries with larger levels of external financing had higher levels of voluntary disclosures, and that an expanded disclosure policy for these firms led to lower debt and equity capital costs, indicating that financial transparency may affect the cost of equity capital.

Companies with better CSR scores experience better equity financing, while investments in enhancing responsible employee relations, environmental policies, and sustainable product strategies contribute to reducing the cost of corporate equity (El Ghouli et al., 2011). Dhaliwal et al. (2014) found a negative relationship between CSR disclosures and equity capital costs, and this relationship is more pronounced in stakeholder-oriented countries. In addition, evidence has also been found indicating that financial disclosures and

CSR act as a substitute for each other in reducing equity capital costs.

Several studies have endeavored to determine the effect of CSR reporting practices on CSR disclosure, while other studies have examined the influence of CSR disclosure on the cost of equity. The aim of this study is to combine the two approaches, i.e. to determine the effect of CSR reporting practices on CSR disclosure as well as the effect of CSR disclosures on the cost of equity capital.

WarpPls 5.0 was used to analyze the data in this paper, with a study sample of 118 manufacturing companies in the period 2013–2015. The results show that companies using a standalone report and Global Reporting Initiative adoption as their CSR reporting practices disclose broader CSR information, and companies that use CSR assurance are not extensive enough in disclosing CSR information. Further, CSR disclosure affects the cost of equity capital in the sense that there is a negative influence between CSR disclosure and the cost of equity capital. It is expected that this research can contribute to the literature by providing empirical evidence on the use of three CSR reporting practices, i.e. CSR disclosure in relation to a standalone report and GRI adoption and CSR assurance, and their effect on the cost of equity capital.

The remainder of this paper is organized as follows. The next section will present the literature review and hypotheses. This is followed by the research method in Section 3 and then the analysis, results, and discussion in Section 4. Finally, the paper will present conclusions, limitations, and suggestions for future research.

2 LITERATURE REVIEW AND HYPOTHESIS

2.1 Legitimacy Theory

Legitimacy theory states that, since a company is part of society, it must pay attention to social norms. Ghazali and Chariri (2007) state that underlying the theory of legitimacy is the corporate social contract with the community, where the company operates and uses economic resources. From the perspective of legitimacy theory, firms will voluntarily report on their activities if management considers this to match the results expected in the broader society (Craig, 2000). With regard to legitimacy theory, all three practices of CSR are used to demonstrate an

effective commitment to CSR and are therefore associated with improved disclosure quality or merely representing efforts to build an image of commitment to positively influence stakeholder perceptions (Michelon et al., 2015). Based on the above, the underlying theory for CSR disclosure is legitimacy theory, since the purpose of CSR disclosure is to obtain positive values and legitimacy from the community.

2.2 Hypotheses

2.2.1 Standalone Reporting and CSR Disclosure

Trends in CSR disclosure and reporting practices show an increasing number of standalone reports (Cho et al., 2011). Companies that publish standalone CSR reports separate from annual reports seem to signal the company's commitment to CSR issues (Mahoney et al., 2013). In addition, a standalone CSR report is considered capable of improving the quality of CSR disclosure (Dhaliwal et al., 2014). Therefore, the first hypothesis is as follows:

H1: Standalone reporting is associated with corporate social responsibility disclosures.

2.2.2 GRI Framework Adoption and CSR Disclosure

The GRI reporting framework is a standard report within the framework of sustainability reporting (Michelon et al., 2015). Following the GRI reporting framework to compile CSR reports, CSR disclosures may increase (Mahoney et al., 2013). The majority of companies who communicate CSR disclosures have adopted this reporting framework. The GRI reporting template was created to guide companies in delivering information about the company and its quantitative or qualitative financial, environmental, and social performance indicators. Therefore, the second hypothesis is as follows:

H2: GRI adoption is associated with corporate social responsibility disclosures.

2.2.3 Assurance of CSR Information and CSR Disclosure

The key element used to ensure the credibility of a sustainability report is external assurance, although external assurance is insufficient for avoiding criticisms relating to credibility (Adams & Evans, 2004). Assurance is only limited to the perception of the company's social and environmental image (Cho

et al., 2014). Therefore, the third hypothesis is as follows:

H3: Assurance of CSR information is associated with corporate social responsibility disclosures.

2.2.4 CSR Disclosure and Cost of Equity Capital

Stakeholder-oriented countries' CSR disclosures tend to be more credible due to the presence of more developed institutions to monitor corporate actions and enforce CSR-related regulations (Ramanna, 2013). Dhaliwal et al. (2011) provide evidence that managing a company's various stakeholders can also be linked to a reduction in the cost of equity capital. If a country is truly stakeholder-oriented, this means that all CSR information is disclosed by means of formal submission and a current voluntary CSR report is disclosed, as it is unlikely to provide much additional information to the market. CSR disclosure and cost of equity capital have a negative relationship, and this relationship is more pronounced in stakeholder-oriented countries; further, financial disclosures and CSR act as a substitute for each other in reducing the cost of equity capital (Dhaliwal et al., 2014). Therefore, the fourth hypothesis is as follows:

H4: Disclosure of corporate social responsibility (CSR) has an effect on the cost of equity capital.

3 RESEARCH METHODOLOGY

3.1 Research Setting and Sample

This study used a quantitative approach with PLS regression using WarpPLs to test the hypotheses. The data used in this research was taken from the firms' websites, the Indonesian Stock Exchange's website, Indonesian banks' official websites, and the yahoo finance website. The sample of this study was 354 firms, from which 118 manufacturing companies listed on the Indonesian Stock Exchange (BEI) during the study period 2013 to 2015 were derived. This study used the sampling census method, which is a sample determination technique wherein all the members of the population are used as samples (Sugiyono, 2002). Detail of the sample selection are outlined in Table 1.

Table 1: Sampling procedure.

	Total
Manufacturing companies listed on the Indonesian Stock Exchange between 2013 and 2015 (143 x 3 years)	429
Excluded :	
Manufacturing companies that carried out IPO and relisting (6 x 3 years)	(18)
Manufacturing companies that did not publish annual reports or sustainability reports (7 x 3 years)	(21)
The data for the variables used were unavailable (12 x 3 years)	(36)
Total Sample	354

3.2 Instruments

CSR reporting practices include companies producing standalone reports, adopting GRI reporting frameworks, or having corporate CSR reports audited.

3.2.1 Standalone Report

The standalone report is a CSR performance report that is separate from the company's annual report. Standalone CSR reports are voluntary. Various names or terms for the standalone CSR report are, among others, sustainability report, GRI report, and environmental report. The instrument to measure this variable was adopted from Michelin et al. (2015), who used a dummy variable equal to 1 if the firm released standalone CSR reports and 0 if the CSR information is in the annual report.

3.2.2 GRI Framework Adoption

GRI is an international standard for sustainability reporting. Companies that follow the GRI reporting framework have a higher level of commitment to CSR than companies that do not follow the GRI reporting framework. With reference to the GRI reporting framework, it is expected that the company will be more transparent to the company's

stakeholders, as well as the information the company discloses being more qualified. As before, the instrument adopted to measure this variable came from Michelin et al. (2015), who used a dummy variable equal to 1 if the document being analyzed contained a statement disclosing the adoption of GRI, and 0 otherwise.

3.2.3 Assurance of CSR Information

Assurance of CSR Information is a guarantee of CSR information that makes the report more credible and increases stakeholder confidence in the CSR information provided. Similar to the two previous variables, the instrument for measuring this variable was adopted from Michelin et al. (2015), who used a dummy variable equal to 1 if the document being analyzed contained an audit statement, and 0 otherwise.

3.2.4 CSR Disclosure

Disclosure of social responsibility based on the G4 Global Reporting Index consists of the following categories: economic (9 indicators), environment (34 indicators), labor (16 indicators), human rights (12 indicators), social (11 indicators), and product responsibility (9 indicators). This CSR disclosure calculation is performed by giving a score of 1 if one item is disclosed and a score of 0 if not disclosed. After that, the score is divided by the number of expected items. In this sense, the number of items disclosed is divided by the number of expected items.

3.2.5 Cost of Equity Capital

Cost of capital is an important concept in the analysis of capital structure since the cost of capital arises due to the use of long-term capital in a company's capital structure. A high level of CSR disclosure will not necessarily lower the cost of equity capital, but the opposite may happen when the company turns out to have problems, especially related to finance. In this regard, with a high level of disclosure, more risky information will be revealed to investors and they will demand a high return on investment, which will consequently increase the cost of equity capital borne by the company (Juniarti & Yunita, 2005). Ross (as cited in Juniarti & Yunita, 2005) states that there are two approaches in determining the cost of equity: the Dividend Growth Model approach and the Security Market Line (SML) or Capital Asset Pricing Model (CAPM) approach. However, this research only used the

CAPM approach because the influence of the disclosure level on the cost of equity is inseparable from the inherent risk factors, and the use of this approach is not limited by the constant dividend growth, so it can be applied to the wider environment. The CAPM calculation is as follows:

$$COE_{i,t} = R_{ft} + \beta_i (R_{Mt} - R_{ft}) \tag{1}$$

Where:

COE = Cost of equity capital

R_{ft} = Risk-free rate.

β_i = Beta of the security

R_m = Expected return on market

4 RESULT AND DISCUSSION

Descriptive statistics provide a description of the variables used in a study.

Table 2: Descriptive Statistics of the variables studied.

	Mean	S.D
Cost of Equity Capital	20.183	294.020
Interval : 0.000 to 0.500		
Standalone Report	0.092	0.046
GRI Adoption	0.091	0.046
Assurance of CSR Information	0.092	0.046
Interval : 0.500 to 1.000		
Standalone Report	0.477	0.205
GRI Adoption	0.383	0.236
Assurance of CSR Information	0.477	0.205

Table 2 presents the results of the descriptive statistics in relation to means and standard deviations. The table shows that the average score for CSR disclosure is 0.092, with a standard deviation (SD) of 0.046, with regard to reports that are not standalone, i.e. which are disclosed inside the annual report, as well as those with no external assurance, i.e. they have not been audited. The

average score increases to 0.477, with a standard deviation of 0.205 on the standalone report and where there is external assurance. The average score for CSR disclosure is 0.091, with a standard deviation (SD) of 0.046, for reports that do not use a GRI reporting framework. For reports using a GRI reporting framework, the average score increased to 0.383, with a standard deviation (SD) of 0.236. In addition, the average score for the cost of equity capital is 20.183, with a standard deviation score of 294.020.

Table 3: Path coefficients and P values.

	Standalone Report	GRI	CSR
Path Coefficients			
CSR	0.709	0.097	
COC			-0.039
P Values			
CSR	<0.001	0.019	
COC			0.283

Table 3 presents the result of the path coefficients and P values. The coefficient for standalone reports to CSR disclosure is 0.709, significant at 0.001. GRI adoption has a positive effect (0.097) on CSR disclosure, with a significant P value of 0.019 (<0.05). Meanwhile, CSR has a negative effect (-0.039) on the cost of equity capital, with a significant P value of 0.283 (<0.05).

Table 4: Latent Variable Coefficient.

	Stand alone	GRI	Assure	CSR	COC
RSquared				0.628	0.004

The coefficient of determination uses R-squared to show how the percentage of endogenous construct variance can be explained by the hypothesized (exogenous) construct. The higher the R-squared,

the better the value (Sholihin & Ratmono, 2013). In Table 4, the value of R-squared for the CSR construct is 0.628, indicating that 62.8% of CSR can be explained by the standalone report, GRI, and assurance variables.

Figure 1 plots the linear relationship between CSR reporting practices using the standalone report and CSR disclosure levels. The results show a linear relationship between the standalone report and CSR disclosure. In interpreting this finding, companies that produce CSR reports separately, i.e. either sustainability reports or CSR reports, will disclose their CSR activities more widely. Thus, it can be concluded that H1 is accepted. There is an association between reporting practices, in the form of self-reporting, and the extent of CSR disclosure. This result is consistent with Mahoney et al. (2013) in regard to the relationship between the standalone report and CSR disclosure.

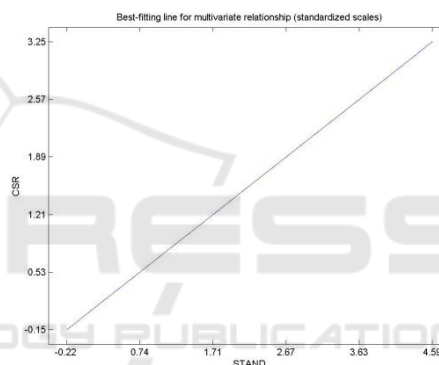


Figure 1: Plot of the relationship between Standalone Report and CSR Disclosure.

The plot of the relationship between GRI adoption and CSR disclosure is shown in Figure 2. In this sense, there is a linear relationship between GRI adoption and CSR disclosure. This result is consistent with Mahoney (2013). Companies that adopt the GRI conceptual framework for their reporting practices tend to disclose their CSR activities more widely. Thus, it can be concluded that H2 is accepted.

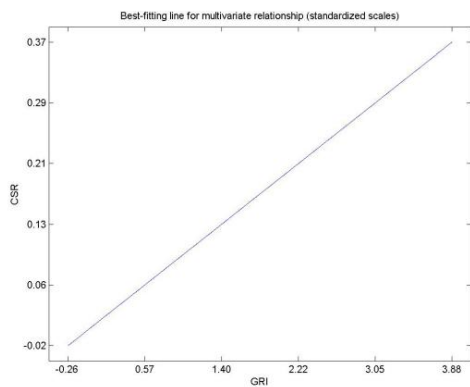


Figure 2: Plot of the relationship between GRI Adoption and CSR Disclosure.

The relationship between CSR assurance and CSR disclosure is shown in Figure 3. The results show that, for companies that report their CSR activities in audits or that are not audited by internal auditors, there is no association with the extent of CSR disclosure. In this regard, it can be concluded that H3 is not accepted.

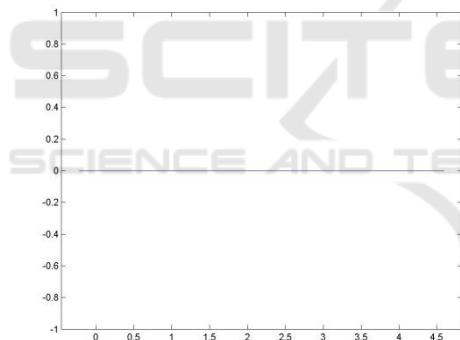


Figure 3: Plot of the relationship between CSR Assurance and CSR Disclosure.

The relationship between CSR disclosure and cost of equity capital is plotted in Figure 4. The first part of the curve shows a U-shape, illustrating that the extent of CSR disclosure will initially lower the cost of equity capital.

At some point, about 4.23 standard deviations for CSR disclosure, the situation changes. In this sense, the company begins raising the cost of equity capital in order to expand its CSR disclosures. This leads to an increase in the cost of equity capital to CSR disclosure of approximately 5.97 standard deviations. After that, an excessive increase in the cost of equity capital can actually lower the extent of

CSR disclosure. Such results are in accordance with the results of the path coefficients, i.e. the effect of CSR disclosure on the cost of equity capital. In Table 2, the influence of CSR disclosure was negative, which is also in accordance with the results in Figure 4, i.e. a high level of CSR disclosure will lower the cost of equity capital and vice versa.

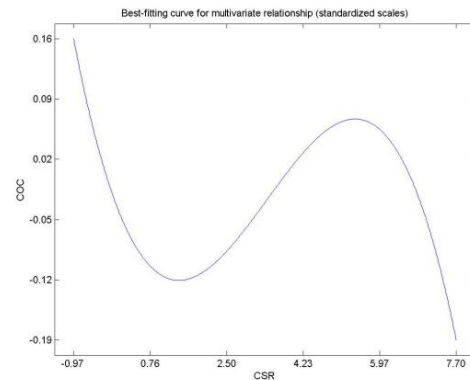


Figure 4: Plot of the relationship between CSR Disclosure and Cost of Equity Capital.

5 CONCLUSIONS

This study aimed to investigate the use of CSR reporting practices as to whether they provide greater disclosure of CSR, in addition to determining the effect of CSR disclosure on the cost of equity capital. Previous research has attempted to examine the association between CSR reporting practices and CSR disclosure, while other studies have examined the effect of CSR disclosure on the cost of equity. However, this study combined both approaches in examining the effect of CSR reporting practices on CSR disclosure, in addition to the impact of CSR disclosure on the cost of equity capital. This study analyzed 354 annual reports and sustainability reports produced by manufacturing companies listed on the Indonesian Stock Exchange during the period 2013–2015. The study used WarpPLS 5.0 as a data analysis tool to test the hypotheses.

The analysis results show that CSR reporting practices in regard to standalone reporting and GRI adoption were associated with the extent of CSR disclosure, but CSR assurance was not associated with the extent of CSR disclosure. This means that companies reporting CSR activities separate from annual reports and adopting a GRI conceptual framework exhibit a much broader level of CSR disclosure when compared to companies reporting

CSR in the company's annual report, and it is not guided by the GRI conceptual framework. Another result from the analysis relates to the CSR disclosure effect on the cost of equity capital, showing an opposing relationship between CSR and the cost of equity capital. In this sense, a high level of CSR disclosure will lower the cost of equity capital.

The results of this study have important implications for the practice of CSR reporting and disclosure. The purpose of CSR disclosure is to obtain positive values and legitimacy from the community. In order for the company to obtain positive values from the community, the company should thoroughly disclose its CSR practices through reporting CSR in a separate report and applying the GRI conceptual framework.

This study has a number of limitations. First, with regard to the research sample, the study only examined manufacturing companies in one country. Second, in measuring the level of CSR disclosure, there is still an element of subjectivity. Third, the use of CAPM to measure the cost of equity capital has the weakness of not reflecting unverifiable risk estimates. Further research could utilize samples from various industries or across countries, which may influence the research results. In addition, future research could examine other matters that may affect CSR disclosure, such as the cost of CSR activities undertaken by the company.

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