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*Lessons from Indonesia*

# Contemporary Issues in Finance, Accounting, and Consumers' Behavior



# Contemporary Issues in Finance, Accounting, and Consumers' Behavior: Lessons from Indonesia

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*Chapter*

# **Corporate Social Responsibility's Effect on Corporate Financial Performance**

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## **ABSTRACT**

This study analyzes the effect of corporate social responsibility (CSR) disclosure on the financial performance of 386 non-financial companies listed on the BEI in 2014. The proxies used as financial performance variables are Market-to-Book (MB) value ratio of equity and Return On Asset (ROA). This research is quantitative with regression analysis. The result shows that CSR disclosure had significant negative effect on MB value ratio of equity because the absence of proper formulation regarding the influence of CSR on financial performance causes investors still to consider CSR activities as only an expenditure. The result also shows that CSR disclosure has no effect on ROA.

**Keywords:** CSR, financial performance, industry type, Market-to-Book (MB) value ratio of equity, ROA.

## **INTRODUCTION**

In recent times, corporate social responsibility (CSR) activities have become of considerable concern to companies. Some countries also give considerable

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attention to CSR by issuing related regulations to stakeholders, both from the implementation and the reporting sides. One such country is Malaysia. In 2006, Bursa Malaysia, the Malaysian stock exchange, issued a CSR framework aimed at providing guidance for companies in Malaysia to develop CSR strategies and to communicate them to their stakeholders. This was followed by the 2007 Prime Minister's speech that states the obligation of public companies in Malaysia to report CSR activities in their annual reports. If the company does not practice CSR, it is obliged to explain that effect on the annual report (Saleh et al., 2011). Another country that does so is South Africa. In 1994, the Institute of Directors in Southern Africa, an organization of professionals promoting corporate governance in South Africa, issued the "King Report on Corporate Governance," basic rules on how to apply corporate governance to companies in South Africa (Ackers & Eccles, 2015). One of the items included in the "King Report" is CSR.

The Indonesian government shows the same concern about CSR. In 2007, the Indonesian government passed a "force" rule on companies engaging in CSR activities, although the rule applies only to companies engaged in certain industries. Law No. 40 (2007) concerning Limited Companies legislates that companies engaged in natural resources or related to natural resources conduct CSR activities. Whereas through Law Number 25 (2007) regarding Capital Investment, the Indonesian government stipulates obligations for investors, i.e., that individual parties or business entities with both domestic and foreign investors conduct environmental social responsibility, that is, CSR.

Regulatory attention to CSR is due to the nature of CSR activities that can affect corporate image. According to Saleh et al. (2011), CSR practices undertaken by a company are considered a way to change the company's reputation, especially a negative reputation. A good or improved reputation will improve company profitability. Increased corporate profitability resulting from better corporate reputation increases repeat purchases and goods' selling prices, in turn increasing revenue and lowering costs due to decreased capital costs and employee costs through reduced employee turnover (Eberl & Schwaiger, 2005). Corporate image also affects the company's market performance because investors pay attention to intangible assets, one of which is corporate image. Investors' opinions of this intangible asset are reflected in the company's market performance (Lee & Roh, 2012).

The difference between this study and previous studies is the samples. This research was able to use various kinds of industries because of changes in companies' CSR performance assessment, which focuses not only on assessment of a company's general social performance, but also in areas of employment, community, and product safety. Assessment points are found in commonly used

CSR indexes, such as the Global Reporting Index (GRI) G4 Index, CSR index of Sembiring (2005), and the CSR index of Sari and Utama (2014).

However, not all CSR indexes can be used in Indonesia because not all disclosure points are applicable there. As example is the GRI G4 index: G4-EN3 mentions points about use of fuels from non-renewable energy, including for transportation, electricity, heating, and cooling. Such reporting cannot be applied in Indonesia because no regulation requires companies to report non-renewable energy use. For this reason, this study uses the CSR index of Sari dan Utama (2014), which includes CSR disclosure points more applicable to Indonesian companies' operating conditions.

Based on this background, the formulation of this research problem is: Does corporate social responsibility (CSR) positively affect corporate financial performance (CFP)?

Therefore, this study was conducted to obtain empirical evidence about the influence of CSR on CFP.

Study results are expected to assist investors in assessing companies' characteristics and provide additional information before using financial statements or in decision-making based on information in financial statements. For regulators, this research is expected to serve as reference information on companies' CSR practices and reasons behind reporting actions. In addition, this research is expected to be considered by regulators in making policies / regulations related to CSR activities.

## **THEORETICAL REVIEW**

Legitimacy and stakeholder theories are often used to explain CSR's influence on CFP. The theory of legitimacy explains that the reason for companies to practice CSR is to maintain legitimacy in the public eye, but especially that of its stakeholders. The theory of legitimacy comes from the concept of organizational legitimacy defined by Dowling and Pfeffer (1975) as "... the condition or status that occurs when the entity value system (firm) is equal and congruent with the larger environmental value system in which the entity becomes a part inside it." The theory of legitimacy is characterized by a "social contract" between the company and the society in which it operates (Deegan 2000; 2002). This social contract is increasingly a concern if corporate survival is threatened when people perceive a company violates its social contract (Deegan, 2002). Therefore, the publication of CSR practices is used to legitimize company operations, so as to maintain its existence and gain greater trust from the public.

The other theory explaining CSR's effect on CFP is stakeholder theory, which states that companies practice CSR to follow the wishes and values of their stakeholders. Freeman (1984) revised the previously existing stockholder theory to (2001) argue that management, especially top management, has an important role in maintaining company health, which includes maintaining balance in relationships among stakeholders. If this balance is not achieved, then company survival will be in danger. Gray et al. (as cited in Chariri & Ghazali, 2007) states CSR activity and disclosure are considered to be one part of the dialog between the company and its stakeholders for maintaining balance within the company.

Research on CSR's influence on companies' financial performance began after Friedman (1970) argued that firms are like artificial people; they have no real responsibility, but company executives actually have the responsibility to operate in a way that will generate profits and accountability to their workers, while obeying applicable laws and codes of conduct. Friedman (1970) confirms his opinion that the sole purpose of CSR is to maximize corporate value.

However, Palmer (2012) argues that, at first glance, Friedman's (1970) examination does not support companies in engaging in CSR because doing so does not provide them benefits. But that is all just misperception. Deeper discussion finds that Friedman (1970) supports integration of CSR activities into business operations, but does not support businesses in naming them CSR initiatives. Friedman (1970) considers CSR a profit-generating activity because companies more often use CSR as a "cloak" for other activities.

Friedman (1970) prompted researchers to conduct studies of CSR influence on CFP. Results of these studies draw differing conclusions. Other researchers (Nursida, 2015; Palmer, 2012; Lee & Roh, 2012; Oeyono et al., 2011) conclude that CSR has a positive effect on financial performance. Palmer (2012) argues that CSR positively affects consumer loyalty. According to Palmer (2012), consumers are more interested in buying products from companies that implement CSR because they feel that, indirectly, the company has helped the community. Oeyono et al. (2011) and Lee and Roh (2012) argue that CSR has a positive effect on companies' financial performance because CSR activities can influence stakeholders' views, especially those of investors, thereby affecting their buying and selling decisions. Nursida (2015) argues that CSR provides a company greater benefits, including increasing the company's value in the public eye and also increasing corporate profits.

In contrast, several studies have concluded that CSR negatively affects companies' financial performance (Putra, 2015; Nursida, 2015). According to Putra (2015), CSR has a negative effect because of the assumption that CSR activities only incur unnecessary costs, which reduce profit. Nursida (2015) stated

the absence of a formula that showing CSR's effect on profits makes most of the world's top entrepreneurs skeptical; they assume that CSR is just a cost component that reduces corporate profits.

Moreover, several other studies have concluded that CSR has no significant effect on financial performance (Johansson et al., 2015; Sebriwahyuni, 2014; Endah, 2013). Johansson et al. (2015) argue that new CSR's influence is seen in several subsequent periods, from 3 to 5 years. Sebriwahyuni (2014) argues that CSR does positively affect a company's financial performance in the long run, in about 5 to 10 years, investors examine in advance CSR's and then decide on investment in the company.

Friedman (1970) argues that corporate stakeholders are responsible for generating company profits in a variety of forms. One of them is CSR activities. According to Friedman (1970), CSR activities are considered a way to generate profits because they affect company value in the public eye—in turn affecting consumers and investor companies. Palmer (2012) argues that positive corporate value can influence consumers to make repeat purchases, thereby improving a company's financial performance. Positive corporate value also affects investors' views, according to Lee and Roh (2012).

Based on these opinions, this study's hypothesis is:

**H1:** CSR has a positive effect on CFP.

## RESEARCH METHOD

As an independent variable, CFP is measured from two perspectives, namely an accounting-based measure and a market stock-based measure. The accounting-based financial performance is measured using ROA, while the financial performance of a stock market-based company is measured by Market-to-Book (MB) value ratio of equity. The formula for measuring ROA and MB value ratio of equity follows:

$$ROA = \frac{\textit{profit after tax}}{\textit{total year - end asset}}$$

and

$$MB \textit{ value ratio of equity} = \frac{\textit{company's market value}}{\textit{company's book value}}$$



*company' s market value* = outstanding shares multiplied by value of year-end market value per share

*company' s book value* = book value of company's equity minus paid in capital of preference share.

An independent variable is CSR, in the form of Sari and Utama's CSR index (2014). See the appendix for a table listing the points of this index.

This research also uses several items as control variables, i.e., firm size, leverage, industry type, and the previous year's CFP. Company size is measured by the total natural logarithm of the asset, leverage is measured by using debt to equity ratio, and the division of industrial type based on Law Number 40 (2007) regarding Liability of Limited Company Article 74 (Law No. 40 [2007], Article 74). Companies required to conduct CSR activities under Law No. 40 are included in the CSR high sensitivity (HSV) category, while the rest are categorized as low CSR sensitivity (LSV). The previous year's ROA and MB value ratio of equity provide CFP.

Sampling used the non-probability method, with these criteria:

1. The company is not included in any financial institution, including banking, financial services, securities, and insurance because the financial industry has different reporting requirements than non-financial industries.
2. Published an annual report audited in 2014.
3. Published audited financial statements of 2015.
4. Had positive equity at the end of 2015.

Financial data is lag-period data (next period after CSR report published) on grounds that new CSR disclosure effects can be felt after CSR activities are reported. This study uses only one year of annual report data because this research intends only to examine CSR disclosure's effect on the company's financial performance, not to determine a trend of CSR disclosure on CFP.

Data analysis used multiple linear regression, with the following model:

$$CFP_t = \beta_0 + \beta_1 CSR_{t-1} + \beta_2 SIZE_{t-1} + \beta_3 LEV_{t-1} + \beta_4 IT_{t-1} + \beta_5 CFP_{t-1} + \varepsilon$$

CFP<sub>t</sub> tahun 2015 = ROA dan MB value ratio of equity (MBV)

$\beta_0$  = intercept estimates

$\beta_1, \beta_2, \beta_3, \beta_4, \beta_5$  = coefficient

CSR = company's CSR

SIZE	=	company size
LEV	=	company's leverage
IT	=	variable <i>dummy</i> for industry type (1 = HSV, 0 = LSV)
CFP <sub>t-1</sub>	=	ROA dan MB <i>value ratio of equity</i> (MBV) year 2014
$\varepsilon$	=	<i>error term</i> that represents the difference between actual CFP and model calculation results

The classical assumption test consists of the residual normality test, heterogeneity, and multicollinearity.

### Research Results

Descriptive statistics for this study's sample of 386 companies are listed in table 1.

**Table 1. Descriptive Statistics of 386 Indonesian Companies**

	N	Minimum	Maximum	Mean	Std. Deviation
ROA <sub>t</sub>	386	-0.8294	1.8517	0.0228	0.1459
MBV <sub>t</sub>	386	0.0000	20.2386	2.3433	3.7186
CSR	386	0.0508	0.8305	0.3679	0.1482
Size (Rp 000.000,-)	386	23.182	236.027.000	7.867.503	18.125.422
Leverage	386	-1.3045	25.7733	0.9770	2.1293
ROA <sub>t-1</sub>	386	-0.3403	0.6089	0.0445	0.0912
MBV <sub>t-1</sub>	386	-2.7888	54.2216	3.0820	6.2260
IT <sub>t-1</sub>	386	0.0000	1.0000	0.1839	0.3879

These results show that the Indonesian sample's average CSR level is 36.79%, still quite low. Although CSR activities have substantially increased, they do not yet fully cover all CSR aspects.

Industry type (IT 1 and 0) variables are dummy variables. Table 2 displays more sensitive industrial types with CSR (high CSR sensitivity; HSV) and less sensitive industrial types (low CSR sensitivity; LSV).

**Table 2. Data Distribution in Indonesian Companies**

	Industry Type	
	IT = 1*	IT = 0

	N = 71	0** N = 315
<b>ROA<sub>t</sub></b>	0.0024	0.0274
<b>MBV<sub>t</sub></b>	2.7217	2.2580

\*IT = 1: HSV and \*\*IT = 0: LSV

HSV companies have a lower average ROA than LSV companies because the HSV category is dominated by mining companies and oil palm plantations that experienced significant profit declines in 2015 (Sukmana, 2015; Wicaksono, 2014). However, investors' interest in both is still quite high because the MB value ratio of equity of HSV companies is still higher than that of LSV companies.

This study uses two dependent variables, ROA and MB value ratio of equity. Therefore, the explanation of the regression result is divided into two parts. Table 3 displays regression results of CSR's influence on ROA free from the classical assumption.

**Table 3. Regression Results of CSR's Influence on ROA**

	Coefficient	t-stat	Prob.
	B		
(Constant)	-0.2187	-1.09	0.1378
CSR	-0.0010	-0.01	0.4955
SIZE	0.0077	0.91	0.1814
LEV	-0.0035	-0.95	0.1695
IT	-0.0266	-1.64	0.0510*
ROA <sub>t-1</sub>	0.6695	4.78	0.0000***
R-Squared	0.2051		
Adj. R-Squared	0.1947		
F-Statistic	19.6135		
Prob (F-Statistic)	0.0000		

The probability value of statistic F of 0.00000 is less than 0.05, so all together, CSR, firm size, leverage, industry type, and ROA of the previous year have a significant effect on ROA.

Table 4 explains the effect of CSR on MB value ratio of equity free from the classical assumption.

**Table 4. Regression Results of CSR's Influence on MB Value Ratio of Equity**

	Coefficient	t-stat	Prob.
	B		
(Constant)	0.7155	0.31	0.3767
CSR	-2.4605	-3.46	0.0003***
SIZE	0.0318	0.38	0.3513
LEV	0.0710	0.81	0.2082
IT	0.0662	0.22	0.4116
MBV <sub>t-1</sub>	0.5007	10.08	0.0000***
R-Squared	0.7164		
Adj. R-Squared	0.7127		
F-Statistic	192.0436		
Prob (F-Statistic)	0.0000		

The probability value of F statistic is less than 0.05, less than 0.05, so all together, CSR, firm size, leverage, industry type, and MB value ratio of equity in the previous year significantly influence the MB value ratio of equity.

## DISCUSSION

### The Effect of CSR on ROA

Table 3 illustrates that the CSR variable has no significant effect on ROA, specifically by the statistical probability value t for that variable being 0.4955, greater than 0.05.

This does not support the initial hypothesis that CSR has significant positive effect on the company's financial performance. Johansson et al. (2015) and Sebriwahyuni (2014) argue that CSR has no significant effect on financial performance because new CSR activities appear to affect medium-term corporate financial reports. Johansson et al. (2015) argue that the effect can be seen only 3 to 5 years after performance of CSR activities. This is evident from Johansson et

al.'s (2015) results that CSR influence was not seen during the first 2 years of the study sample, but only in the last 2 years.

Sebriwahyuni (2014) believes that new CSR's influence is seen about 5 to 10 years after its implementation because consumers and stakeholders first examine the influence's magnitude and consistency of implementation in, for instance, the environment, communities around the company's operational location, and the general public. If most customers are satisfied with the company's CSR performance, this leads to customer loyalty to the company's products. According to Eberl and Schwaiger (2005), consumer loyalty increases the number of repeat purchases and the selling price of goods, in turn increasing revenue. The company's cost also decreases due to reduction of capital and employee costs by reduction of the employee turnover rate. Increased revenues and decreased expenses certainly increase the company's profitability.

### **The Effect of CSR on MB Value Ratio Of Equity**

Table 4 shows that CSR has significant negative effect on the MB value ratio of equity, as shown by the value of  $t = -3.46$ , and the statistical probability value  $t$  for that variable is 0.0003, greater than 0.05

This result does not support the initial hypothesis that CSR has significant positive effect on the MB value ratio of equity. Nursida (2015) argues that CSR has a significant negative effect on the CFP because no formula can consistently show CSR's influence on financial performance. Such a formula's absence makes the owners of large companies and entrepreneurs skeptical about CSR's impact on CFP.

This skeptical view then raises negative opinions about CSR's influence on companies' financial performance. Putra (2015) and Lopez et al. (as cited in Palmer, 2012) argue that this skeptical view then makes investors see CSR as just a cost component that reduces company profit, not as an investment activity that can improve the company's earnings. Negative views then make investors reluctant to invest in companies that "squander" assets to conduct CSR activities. The investors' unwillingness to invest their capital decreases financial performance, especially market performance, which is reflected in the market value of the company's stock price.

### **The Effect of Previous Year's Financial Performance on ROA and MB Value Ratio of Equity.**

The regression analysis result shows that only last year's financial performance variable has significant effect on companies' financial performance, as indicated by the statistical probability value  $t$  for variables ROA and MB value

ratio of equity the previous year being 0.0000, less than 0.05. The direction of ROA and MB value ratio of equity of the previous year is positive, shown by the coefficient value 0.6695 for ROA and 0.5007 for MB value ratio of equity.

This result supports the study's initial hypothesis. According to Amalia (2008), investors in Indonesia argue that a company with a good ROA value in the previous period will have a good stock performance. This will attract investors to invest their capital, so the company has a large supply of funds, which will provide the company more opportunities to generate greater profits. While Pontiff and Schall (1998) argue that the MB value ratio of equity has a positive effect on the firm's market value because it can predict the future market value of the company, represented by MB value ratio of equity next year. The reason, according to Pontiff and Schall (1998), is that the book value ratio, used in the formula to calculate the MB value ratio of equity, is a measure of future cash flows. The relationship concludes that firms with positive book value will generate positive future cash flows as well, and vice versa. A positive cash flow will result in greater profits for the company.

Additional analyses were then undertaken to discover any significant differences in results of analyses between company data required to perform CSR activities by the government (HSV) and firms listed on the BEI in 2014. Results from additional analyses also showed similar results to those of regression analysis. Previously, CSR had no significant effect on ROA and significant negative effect on MB value ratio of equity.

## CONCLUSION

Based on research results, the CSR variable has significant negative effect on variable MB value ratio of equity and no significant influence on ROA variable. Table 4 shows that the coefficient of CSR is  $-2.4605$ . This reveals that every one point increase in the CSR variable decreases the value of MB value ratio of equity by 2.4605 points.

Control variables that have significant effect on ROA and MB value ratio of equity are the previous year's financial performance, which is represented by ROA and MB value ratio of equity of that year. Table 3 shows that a one-point increase in ROA in 2014 increased ROA by 0.6695 points in 2015. Table 4 shows that a one-point increase in MB value ratio of equity in 2014 increased MB value ratio of equity by 0.5007 points in 2015.

## RESEARCH SUGGESTIONS

1. The choice of measuring instruments for assessing CSR information presentation of Indonesian companies is still limited. This might cause a non-objective measurement because the method does not align with the custom of CSR information presentation in Indonesia. Future research should use more suitable measurement tools, such as independent agency assessment results on CSR levels of firms in Indonesia or by adapting CSR indices frequently used in Europe or the United States, for example, the GRI index.
2. The choice of tools to assess companies' stock performance in Indonesia is also still limited. This may cause measurement results to misrepresent actual company stock performance. Future research should use more sophisticated stock performance tools, such as Tobin's Q or abnormal return.
3. The year period of CSR report issuance is still limited. This led to conclusions as yet unable to illustrate CSR's overall influence on the company's financial performance. Future research should increase years of the research sample or lengthen the lag period between the CSR report's issuance year of with financial report, for example, by 3 or 5 years.

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