The Influences of Sustainability Report and Corporate Governance toward Financial and Entity Market Performance with Political Visibility as Moderating Variable

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ABSTRACT

The aim of this research was to identify the effect of corporate governance and sustainability report on the financial performance of entities, and corporate governance and sustainability report on the market entity with political visibility as moderating variable. Sustainability report was measured by a dummy variable by the Corporate Governance Scorecard with Indonesian Institute for Corporate Directorship (IICD). Then, financial performance as measured by profitability ratio (ROA) and Liquidity Ratio (CR), as well as the market performance were measured using Tobin’s Q. Meanwhile, the political visibility was measured by the log of total assets. The analysis of the data used Path Analysis method with Structural Equation Modeling (SEM). The analysis shows four results by using political visibility as moderating variable. First, the quality of corporate governance affects the financial performance. Second, the quality of corporate governance influences Tobin’s Q. Third, the sustainability report has an effect on the Return on Assets and current ratio. Last, sustainability report also affects Tobin’s Q.

Keywords: sustainability report, corporate governance, performance profitability, Tobin’s Q, political visibility

INTRODUCTION

Corporate governance is effective in ensuring that stakeholder’s interest is protected (Said, Zainuddin, & Haron, 2009). Corporate governance is expected to function as the instrument of assurance to investors that they will get profit from the fund they have invested in the entities. Therefore, entities must disclose their aspects of the economy, social, and environment performance, and their sustainability as a form of accountability to investors and stakeholders, so that the application of Good Corporate Governance (GCG) concept is expected to improve the implementation and disclosure of social responsibility entities (Daniri, 2008).

Furthermore, the application of corporate governance in entity’s performance is a successful key to get profit in a long term business and to compete in global business well. Previously, there are many issues in Indonesia about how poor the application of GCG in entities’ performance has been. The result of a survey done by McKinsey and Co. (2002) in Sayidah (2007) stated that investors avoided entities which had the bad label in corporate governance. The attention given by investors to GCG is as big as the attention to entities’ financial performance. Investors feel confident that entities applying GCG have attempted to minimize the risks of decision that only benefit themselves. Thus, it will improve the performance of entities which in turn can maximize entities’ values.

The goal of entities is always related to profit alone without any social responsibilities to the public. This declines public trust to entities. The disclosure in the sustainability report is expected to increase public confidence, and the reliability of entities in maintaining consumer, human resources, and the
wealth management that have an impact on entities’ profit. A different opinion is expressed by Guidry and Patten (2010). They said that the disclosure of sustainability report would not affect entities’ market. This was because investors would not pay attention particularly to reports issued by entities. On the other hand, Alewine and Stone (2010) found that social information disclosure affected the stakeholders and financial performance of companies (Soelistyoningrum, 2011). Then, to see the entities’ financial performance, the financial ratio can be used as a measurement. The financial ratio shows the relationship between elements in a financial report that are stated in the form of simple mathematics (Sugiono & Untung, 2008).

Sustainability in forestry science approach underlies the emergence of the sustainability concept that is as an effort or action of not exploring the capabilities of forest harvesting in normal conditions. Sustainability can also mean as an effort to preserve the natural resources for the future (Kuhlman & Farrington, 2010). From both meanings, it can be seen there are two different points of view regarding the relationship between man and nature. Those are the point of emphasizing adaptation and harmony, and the point of seeing nature as something to be conquered. Both points of view force entities to conduct more transparent disclosure. This clearly increases the pressure on entities to collect, manage, and publish the sustainable information. Thus, sustainability report becomes the key to communication strategy for managers in delivering their activities (Falk, 2005). This communication form is growing in the entities’ sustainability report by discussing annually the environment, health, and safety. This discussion makes sustainability report to become a major concern in non-financial reporting which includes four main categories. Those are business landscape, strategies, competencies, resources, and performance of the entity (Falk, 2005).

A sustainability report is one of the media to describe the reporting of economic, environmental and social impact of the triple bottom line concept, CSR reporting, and others. This is because the practice of measuring and expressing the activity of an entity is used as a responsibility to all stakeholders on the organizational performance in achieving sustainable development goals.

Disclosure in the sustainability report is also used by government institutions. For example, in the Ministry of Environment in every disclosure organization report about an assessment of the performance of an entity on the environment, it is written in rules that have been established as a stand-alone report although there are still many implements of sustainability report disclosed together with an entity’s annual report (Gunawan, 2007). Disclosure sustainability report must comply with certain principles. Those principles are contained in GRI-G3 guidelines, which are balance, comparability, accuracy, time sequence, suitability, and accountability.

Next, political visibility is all expenses incurred by the entity to report and express the whole social information related to the entity’s economic activities. The costs are incurred to meet public pressure or to improve the image in public. The cost is a result of the entity’s decision to disclose social information as a form of social responsibility of the entity itself. These costs will clearly lower the revenue.

The expenses incurred are because the entity has been criticized by groups with interest in reducing the entity’s revenue reported, and modify or reduce their political visibility (Belkaoui & Karpik, 1989). Political visibility of the entity is generally measured by indicators of a larger size, greater capital intensity, and higher risk of the systematic market. The social responsibility disclosed in the sustainability report actually does not exist, but most of the entities do the actual disclosure to avoid the pressure from social activists as described by Fry and Hook (1976) in Belkaoui and Karpik (1989).

Then, the temporary allegation for political visibility mentions that the greater political visibility faced by the entity is, the lower present profit is gotten by an accounting procedure chosen by a manager compared to future profit. Therefore, the higher political visibility faced by the entity is, the more expenses incurred for disclosing social information will be that the profit reported becomes lower (Watt & Zimmerman, 1990 in Scott, 2009).

Political visibility can also be reflected by the firm size. Large entities (large size) generally do the planning for the costs incurred for activities of social disclosure in preparing the detailed social information disclosure and planning for the risks that might occur. This will generate large entities to get higher profits compared to small entities because large entities get benefits through social disclosure that is beneficial and able to give information to the shareholders in the capital market. (Singhvi & Desai, 1971 in Arcay & Vazquez, 2005). Chen and Metcalf (1980) in Ballabanis, Phillip, and Lyall (1998) revealed that the size of entities influenced the implementation of corporate governance and the financial performance.

Cowen, Ferreri, and Parker (1987), and Watts and Zimmerman (1986) in Arcay and Vazquez (2005) stated that theoretically, large entities would not escape from the pressure of public criticism or intervention from governments. Therefore, the greater disclosure is a political cost reduction as a form of entities’ social responsibility. Large entities with operating activities and great influences on society are possible to have shareholders who pay attention to the social programs created by the entities. Hence, the social responsibility disclosure of the entity will be more extensive. Large entities are likely to provide present profit lower than small entities. It is because a larger entity has a considerable push to equalize profits than a small entity. Then, large entities tend to spend more on the disclosure of social information than small entities. The size of entities can be represented by market capitalization, total assets, sales logs, and others.
Next, performance is an ability to work shown from the outcome obtained. Performance measurement is a way made by the management to fulfill its obligations to donors as well as to fulfill the goals set up by the previous entity. The financial performance measurement has the important role of decision making for both the internal and external of an entity. Moreover, financial performance measurement can be done by ratio analyzing. Ratio analysis is a figure which shows the relationship between the elements in the financial statements. That relationship is expressed in a simple mathematical form (Sugiono & Untung, 2008). Ratio analysis is used to determine the entity’s financial situation and development.

One of the ratios used to look at the fundamental financial condition of the entity is the profitability ratio. This ratio is used to measure the extent of the entity’s ability to generate profits (profitability). Profitability ratio is also used as a measurement of the effectiveness and efficiency of the use of all resources that are in the process of the operational entity to give attractiveness for investors who will invest their funds in the entity. Several indicators used as a tool in calculating profitability ratio are Return on Assets (ROA), Return on Equity (ROE), Net Profit Margin (NPM), and Current Ratio (CR).

Market value is used as an indicator in measuring the market performance in this research. The market value is the entity value perceived with stock prices by investors. Then, stock prices are the prices formed in the stock market. In general, the entity’s stock price is acquired to calculate the value of the shares of the entity. The value of high shares would make the value of the entity high too. One of the alternatives that can be used in measuring the value of the entity shares is by using the Q Ratio or better known as Tobin’s Q. The measurement of the stock value using Tobin’s Q is used in researches in the field of economics (microeconomics, finance and investment studies). Tobin’s Q is used as an added-value measure of Marginal Q to describe the entity’s investment decision which is based on the profit margin. Tobin’s Q is a measure of performance that compares two assessments of the same assets. The hypothesis of Tobin’s Q suggests that the market value of the entity’s assets measured by the market value of the outstanding shares and debt (enterprise value) of the replacement cost of the entity’s assets should be the same. If the Q ratio is low between 0 and 1, the cost to replace the asset value should be greater than the value of its shares. It means that if an entity has a value greater than the previous base value, it will have cost to increase the value again, and profits are likely to be obtained. If the Q Ratio is high or more than 1, it can be interpreted that stock value is much more expensive than the cost of replacing asset or investment costs. This situation implies that stock prices are over-valued. This stock value measurement is the motivating factor behind the investment decisions in Tobin’s model. The measurement increased during a market boom in 1990 when researchers noted that the overall value of Tobin’s Q seen relatively high as the historical norm. Based on Tobin’s thought, the incentive to create new investment capital is high when securities (stocks) that provide benefits in the future can be sold at a price higher than the cost of investment (Fiakas, 2005). In addition, the increasing of the market performance of an entity is affected by the disclosure of environmental performance (Belkaoui & Karpik, 1989). It is concluded that the transparency of the entity through disclosure on sustainability report, which is a voluntary report, means that the entity is concerned about the environment.

Similarly, the implementation of corporate governance brings great benefits to the entity. There are the improvements of financial performance and operational performance. It is because the benefits of corporate governance earned can create a better decision-making process, improve the operational efficiency of the entity, and improve services to stakeholders. Several researches have been conducted to examine the effect of corporate governance on the performance of the entity. One of the researches was conducted by Pranata (2007) who found that the application of corporate governance had positive effects on the performance of the entity.

The information that is clear, consistent, comparable and acceptable by using worldwide accounting standard can guarantee that the information is valuable in the global capital markets. The information presented is valuable, so entities have a rating in corporate governance. McKinsey and Co. (2002) conducted a survey with results indicating that investors avoided the entities with a bad image in corporate governance. Investors believed that the entities which applied corporate governance had made a serious effort in minimizing the risk of wrong decisions that would be only profitable for the entities themselves.

Soelistyoningrum (2011) suggested that the disclosure of sustainability report positively affected the performance of the entity. A sustainability report is considered as an attempt to communicate the management performance in achieving a long-term profit of an entity to stakeholders such as improved financial performance, maximized profit, and a long-term success of the entity. They state that the information in the sustainability report can be one of the entity’s campaign media to the public that the positive attitude of society towards the entity is greater. This positive attitude has an impact on the performance and the entity’s ability to earn a profit.

Moreover, Guidry and Patten (2010) suggested that the entity with the high-quality sustainability report level had a more positive market reaction than lower quality. The value of stocks reputation is increased only when the actions of entities rated show their social responsibility. Hence, it is very often for the entity to use the sustainability report as a tool to improve the reputation of the entity. The sustainability report is seen as a positive action in which an action creating positive values to the reputation of the entity.
shares must meet two criteria. First, the ethical value of such action must be consistent with the ethical values of society. Second, the measures should not be considered as a business attempt to attract attention to raise public attention (Guidry & Patten, 2010). A sustainability report is also a voluntary presentation. Investors also prefer the presentation of financial statements that are more complete in accordance with their needs, so the entity will often exceed the financial statement presentation than the standardized one, and present more comprehensive performance information to boost the reputation of the entity.

The purpose of this research is to identify the effect of corporate governance and sustainability report toward financial and entity’s market performance which are moderated by political visibility. Moreover, the results of this research are expected to obtain some information. First, it is about the influence of corporate governance and sustainability that significantly affect the financial performance and the performance of the enterprise market in Indonesia. Second, it is to add insight in applying the concept of GCG and Corporate Social Responsibility (CSR) for the company.

To support this research, there are several hypotheses as shown in Figure 1. First, there is a positive influence of corporate governance on the financial performance with political visibility as moderating variable. Second, there is a positive influence of corporate governance on the market performance with political visibility as moderating variable. Third, there is a positive influence on the sustainability report on the financial performance with political visibility as moderating variable. Last, there is a positive influence on the sustainability report on the market performance with political visibility as moderating variable.

**RESULTS AND DISCUSSIONS**

**Dependent Variables: Financial Performance and Market Performance**

| Variables   | Coefficients | Coefficients |
|-------------|--------------|--------------|
| CG * PV     | 1.092***     | 0.927***     |
| SR * PV     | 0.124***     | 0.114***     |

Notes: Path Analysis Method by Structural Equation Modeling (SEM)

*** P < 0,01. Correlation is significant at the 0,01 level
** P < 0,05. Correlation is significant at the 0,5 level
* P < 0,1. Correlation is significant at the 0,1 level

The research result of hypothesis 1 shows that the political visibility represented with the log of total assets serves as a moderating variable of the corporate governance toward financial performance (ROA and CR). The course of the relationship between corporate governance with ROA and CR indicates a positive interaction with a regression coefficient of 1.092 with a significant level 0.0001 which is less than 0.05 as seen in Table 1. It can be concluded that the political visibility strengthens the relationship of corporate governance with financial performance. It means hypothesis 1 is received.
Moreover, the research result of hypothesis 2 shows that the political visibility represented with the log of total assets serves as moderating between the corporate governance toward the market performance (Tobin’s Q). The relationship between corporate governance with Tobin’s Q in Table 1 indicates a positive interaction with a regression coefficient of 0.927 with a significance of 0.001 less than 0.05. This suggests that the quality of corporate governance can increase the size of companies by improving market performance represented by Tobin’s Q. It means that political visibility is to function as a moderating variable.

Next, the research result of hypothesis 3 shows that the political visibility represented with the log of total assets serves as moderating variable of the sustainability report toward the financial performance (ROA and CR). In Table 1, the relationship between sustainability report with ROA and CR indicates a positive interaction with a regression coefficient of 0.124 with a significance of 0.005. This suggests that the larger size companies tend to be more revealing in social responsibility that cannot be denied and can improve the financial performance.

Similarly, the result of hypothesis 4 shows that the political visibility represented with the log of total assets serves as a moderating relation of the sustainability report toward the market performance represented by Tobin’s Q. The relationship between sustainability report and Tobin’s Q indicates a positive interaction with a regression coefficient of 0.114 as shown in Table 1. This suggests that larger size companies tend to influence the market performance (Tobin’s Q) by disclosing their sustainability report.

Good corporate governance can be described as a system that directs and controls entities to achieve a balance between authority and the accountability to the stakeholders. The balance of entities’ authority and accountability for stakeholders is related to the regulatory authority of the owners, directors, managers, shareholders, and others. That balance must fulfill the principles of good governance proposed by the Forum for Corporate in Indonesia (FCGI). The principles are accountability, responsibility, independence, and fairness. The implementation of GCG principles would clearly have benefits for the entities. Those benefits are a) the increase of entity’s performance; b) easily obtaining funding fund because of the trust factor; c) reinstating investors’ confidence; and d) the satisfaction of shareholders on the performance of the entities.

The benefits of corporate governance application for the entity clearly improve the performance of the entity. This affects the internal control better so that the entire management of the entity is more effective and efficient. Professional management which is effective and efficient becomes an element to generate a better profit margin too.

The establishment of corporate governance on an entity can substantially affect shareholders. This happens because the corporate governance mechanism is done well. Corporate governance mechanism can also ensure the management to act in accordance with the objectives and interests of the entity. Moreover, investors’ confidence and market efficiency are highly dependent on the disclosure of information on the performance of the entity that is done on time and accurately (Pradita, 2009).

Sustainability report framework is one of the ways done by the entity in managing the relationship with its stakeholders hoping to provide tangible evidence of the production process that does not only focus on profit alone but also pay attention to social and environmental factors. It gives more value to the entity including the confidence of investors, suppliers, and customers that the entity takes concern on its sustainability by presenting a voluntary report. The increasing trust indirectly gives impact on the increase of operating activity which indicates that there is an increase in the entity’s financial performance in the future.

A sustainability report is also the entities’ efforts to maintain good relations and the confidence of investors to invest in the entities. Besides that, it could attract the interest of consumers and suppliers as well as the interest to purchase their products, which indirectly could cause the entity’s survival, especially in operation. It could still run and increase properly. With the continuity of the better activities of the entity, and the attraction from customers, suppliers, and others to buy more products from the entity, it is expected to have an impact on improving the market performance of an entity for years to come after the disclosure of sustainability reports indirectly.

The influence of the political visibility existence as the moderating variable is proven to be significantly positive toward corporate governance, sustainability report, financial performance, and market performance. This is consistent with the research results of Belkouai and Karpik (1989), Patten (1991), Patten (1992), Gray, Javad, Power, and Donald (2001), Katsuhiro, Akihiro, Yasushi and Tomomi (2001), Hasibuan (2001), and Yuliani (2003). The two theories used in this research (the agency theory and the theory of legitimacy) are supportive of the argument for the relations between the size of enterprises, corporate governance, social responsibility disclosure, financial performance and the market performance. In addition, according to Cowen, Ferrerí, and Parker (1987), big companies that conducted more activities by giving greater impacts on society were likely to have more shareholders that might be associated with the company’s social program. Furthermore, the annual report would be used as an efficient tool to disseminate the information.

CONCLUSIONS

There are several conclusion based on the result. First, the quality of corporate governance affects the return on assets and the current ratio by using political visibility as moderating variable. Second, the quality...
of corporate governance has an effect on Tobin’s Q by using political visibility as moderating variable. Third, sustainability report influences ROA and the current ratio by using political visibility as moderating variable. Last, sustainability report affects Tobins’ Q by using political visibility as moderating variable.

For next research, researchers can use several criteria to determine the sample and research span (period), the size of the board of directors, the compensation of directors, managerial ownership, audit committee, independent commissioners as the indicators of GCG. Moreover, they can use the measurements of the number of employees, the log of total net sales as political visibility variable.

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