Journal of Humanities, Language, Culture and Business (HLCB)
Vol. 1: no. 2 (2017) page 168-180 | www.icohlcb.com | eISSN : 01268147 |

CORPORATE SOCIAL RESPONSIBILITY DISCLOSURE AND COST OF EQUITY CAPITAL IN INDUSTRIAL PRODUCT INDUSTRY

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Abstract

Corporate Social Responsibility (CSR) disclosure is now becoming an increasingly popular topic of discussion. Through a strategic approach to CSR, companies are able to boost its competitiveness while gaining other benefits from risk management, reducing cost, and better access to capital, innovation and development. The main objective of the study is to investigate the CSR disclosure by companies listed under industrial product industry toward cost of equity capital. The CSR disclosure score is measured by the extent of CSR disclosure in the annual report. A total of 59 samples of annual reports of listed companies for the periods 2012 to 2014 were obtained and examined. After accounting for control variables such as company size, liquidity, and board independence, the regression results showed CSR disclosure, and other control variables such as liquidity, and board independence had negative relationship with cost of equity capital. However, only company size has positive relationship with the cost of equity capital. The results revealed that the CSR disclosure in the annual reports reduces the cost of equity capital by reducing the information asymmetry and thereby reducing the companies' risk. For future research, this paper recommends the study be expanded by using other CSR index and measurement of cost of equity.

Keywords: Corporate Social Responsibility, Cost of Equity, Cost of Capital

2017 JHLCB

Introduction

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The trending of present globalization and demand for share prices appreciation increase the expectations of stakeholders toward companies to implement corporate social responsibility (CSR) policies and practices that will motivate the participation in CSR activities (Chapple & Moon, 2005, Verbeeten et al. (2016).). The CSR Framework 2007 is only a guideline for companies to implement CSR, it does not mention on the details and items that should be disclosed. In Malaysia, the authority such as Security Commission (SC) gives support to encourage CSR activities development. Assistances in kind provided by SC will increase the participation of Malaysian companies in CSR activities. Malaysian companies have increased CSR activities recently, for example Petronas. The company has integrated business with the environment and contributed to the well-being of the people and the nation wherever they operate. They have invested in CSR by having corporate social investment (CSI) initiatives in three main areas: education, community well-being and development and environment.

Over the years, the CSR concept has grown continuously in its importance and implication. CSR will benefit the companies with better public image. According to a survey, 90% of the consumers would drag back the decision of dealing business with a company if that company do not have corporate social responsibility plan. Followed by brand differentiation, companies which embrace CSR will also gain support from the effect of better public image. CSR requires both internal and external engagement which are customer engagement and employee engagement to promote the development of the company and explore new opportunities. A successful CSR plan is one of the main keys to assist a company to achieve higher competitive market power.

The significant increase in CSR has led to a concern towards the relationship between CSR and cost of equity capital. The advantages of being straightforward in its CSR exercises has been found in the decline of cost of capital (Dhaliwal et al., 2011; Derwall and Verwijmeren, 2007, Matthiesen and Salzmann, 2017); decrease in informational asymmetry and transactions expenses (Lambert et al., 2007, Amihud and Mendelson, 1989, Lopatta et al., 2016). In practice, managers often have better information than outside stockholders. This information asymmetry has important implication on CSR because managers know much better about the company's CSR engagement in terms of goal, plan, program, and related activities than outsiders. Cui et al. (2016) believed that being straightforward in CSR disclosure can improve financial communications to shareholders and higher company's market value.

Malaysia gives a decent setting to explore the relationship between the legal framework and capital market which is both sensibly very much developed (Mohamad et al., 2007). However, the lawful requirement to counter aggressive financial reporting and accounting misrepresentation is not solid (Hasnan et al., 2013). Capital market transaction hypothesis is the reason why companies are willing to disclose more such as CSR disclosure (Healy and Palepu, 2001, Choi and Moon, 2016). The companies that have the incentives to disclose more information could enjoy a lower cost of capital, the reduction of such cost being associated to information risk. If CSR affects the company's risk bearing, companies with CSR activities should gain benefits from lowering the financing the cost of issue equity share. The more prominent level of CSR exposures the higher the liquidity, specific as far as the value impact. Some studies recommend an opposite causation where level of corporate liquidity is an essential determinant of the level of disclosure in both corporate monetary and non-money related data (Ho and Taylor, 2007, Schoenfeld, 2017). Specifically, they show those organizations with higher liquidity may have more grounded motivations to give more money related and non-monetary data in their yearly reports than organizations with lower liquidity.

Problem Statement

The topic of CSR is not a new issue and has been debated and starting to get concerned from various parties. The companies are struggling that to undergo practice of CSR since it involve additional investments in CSR indirectly decrease cost of equity. The benefits from CSR are the main factor that drives CSR investment has been examined through the economic cost-benefit analytical lens (applying other's conclusion to a new case) moreover enhance the corporate reputation and goodwill. There is an argument that CSR activities rise costs without achieving its par value benefits to companies, weaken performance and disarrange with value-maximizing activities. These include making charitable donations, evolving policies for community development, and environmental voluntary activities.

Corporate social responsibility (CSR) endorses a vision of business liability to a wider variety of stakeholders, besides shareholders and investors. The factors concerned are environmental conservation and the welfare of employees, the community and civil society in the future. The concept of CSR is pressed that corporations can no longer act as insulated economic beings operating in detachment from bigger society. In the previous days, governments have to convey public and environmental objectives via relying on law and regulation in the business sector. Reduction in administration funds, comes with a mistrust of rules and regulations, has caused the consideration of CSR and non-regulatory initiatives instead.

The link between CSR and cost of equity is important to be identified. If company's perceived riskiness affected by CSR, then the companies which undergo CSR should benefit in terms of lowering cost of equity. According to El Ghoul et al. (2011), most of the previous studies focus on accounting-based of financial performance; few studies examine the capital structure participant's view toward CSR. Therefore, it is important to understand the relationship between CSR and cost of equity in Malaysia helps managers on company's strategic planning.

Research Questions

Based on the problem statement of this study, the effect of corporate social responsibility (CSR) is determining the cost of equity capital in Malaysia. Besides, there are other factors affect CSR disclosures. Therefore, the several research questions of this study are as follow:

1. Is there any significant relationship between CSR disclosure and cost of equity capital?
2. Is there any significant relationship between company size and cost of equity capital?
3. Is there any significant relationship between liquidity and cost of equity capital?

4. Is there any significant relationship between board independence and cost of equity capital?

Literature Review

According to McWilliams and Siegel (2001), CSR can be defined as "engagements that seem to supplementary of social welfare outside the interest of the company which is obligatory by law". CSR means that social events interconnected to stakeholders by using a company's annual reports (Mohd Ghazali, 2007; Ahmad et al., 2003). Hence, all the CSR activities that revealed by companies in annual report is represented by CSR disclosure. Bassen et al. (2006) study in the part of North America or Europe, and find that great CSR execution reduce general risk of a company being contrarily seen by investigator sand speculators, and thus prompts less costly equity financing. The estimation of CSR is seen distinctively around the world, while these discoveries might just apply to companies in North America or Europe, where CSR has been advanced for a long time. Muirhead et al. (2002) suggest that more than half of the U.S. and European managers look CSR as very effective, while Asian managers rate CSR as not very effective towards the success of company.

Rival of CSR argue that companies just do such endeavors to upgrade their reputations with stakeholders for business advantages, to draw in more workers, to decrease turnover rate and training expense (Prior et al. 2008). Teoh and Thong (1984) found that the reason why CSR disclosure in Malaysia is still in its growth stage is insufficient of stricter rule and regulation on CSR disclosure and the companies has the perception of they will not get any benefit from the municipal or stakeholders. This situation cause shareholders are less likely to invest in CSR activities. Although companies has been pressured by stakeholders that to be more actively in social responsibility activities, the extra companies involved in social responsibility still unable to fulfill the stakeholders' will (Williams and Pei, 1999, Oliveira, 2015). Government of Malaysia is aware about the importance in CSR disclosure practice and provide many initiatives and incentives to encourage companies engage CSR activities (Amran et al. 2013).

Prior studies examine whether CSR affects company value. Starks (2009) suggests that there is an important mechanism that CSR affecting cost of equity by its effect on company's risk which investors see high social responsibility company having lower level of risk. Other than that, reduced information asymmetry because of higher transparency of information discloses also lowering cost of equity. There is an empirical evidence suggests that high CSR companies have a tendency to disclose more information in order to reduce cost of equity while projecting a positive image towards investors and stakeholders. Investors look low CSR companies having high level of risk pointed out from previous studies (Robinson et al., 2008; Starks, 2009, Schoenfeld, 2017). According to Waddock and Graves (1997), there is an argument that low CSR companies may lead to uncertain future unambiguous assertions. Companies implementing a supplementary ecologically proactive position gain a significant lower perceived risk to shareholders. After that, the extent of CSR also improves company net worth and lower risk profile (Mishra and Modi, 2016). Dhaliwal et al (2011) claim that lowering the information asymmetry, the CSR could help in reducing the cost of equity capital accordingly to the relevant dimension. Some recent studies prove significant negative relationship CSR disclosure and cost of equity capital (Reverte, 2012, Feng et al., 2015 Xu et al., 2015, Matthiesen and Salzmann, 2017).

This study is to determine how corporate social responsibility disclosures in the annual report affect a company's cost of equity capital. This study also purposely is to examine relationship between company characteristics and cost of equity capital. The company characteristics for this study are company size, liquidity and board of independent directors.

Methodology

Sample

This study use sample of 59 annual reports company listed under industrial industry for period of study 2012-2014. According to Keller and Warrack (2005), the sample should contains observations of at least 30 companies is considered to be representing the population. Some industries such as financial, services, and utilities companies are excluded in the study because their sales are irregularly disclosed. Companies that have incomplete data throughout the three-year period are excluded.

Data such stock price and interest rates are collected from the Worldscope and Bank Negara website. They are used to determine the cost of equity capital. The CSR disclosure and Independent director data are collected manually from annual reports of the companies. While the other remaining two financial control variables such as size, and liquidity are collected from DataStream and Worldscope.

Corporate Social Responsibility

To measure CSR in Malaysia, this study modified the prior study of Yeh et al. (2011) method, which is "The Expert Assessment System for CSR China Honor Role". This approach contains 11 items disclosed in four dimensions. The four dimensions consist of environmental management, quality management, employee protection, and sound corporate image stated in appendix 1.

$CSR_i = \Sigma X_i / n_i$
Where n_i = number of items expected for i company, $n_i \leq 11$
$X_i = 1$ if the item is disclosed, 0 if the item is not disclosed,
so that $0 \leq CSR_i \leq 1$.

The statement of the weight should be attached to the items of disclosure in order to value the information is a very significant issue that needs to be addressed while using the disclosure score. The weighted score measured the amount of information with an assigned weight from the items of information. It is reasonable to use the weight for items because this weight helps to differentiate the relative importance of items of information to the investors and other users of accounting information (Inchausti, 1997, Fisher, 2016).

The Cost of Equity

According Botosan (2000), the cost of equity (COE_i) is measure based on the Capital Assets Pricing Model (CAPM). The COE_i is equal to sum of the expected risk free rate, the product of a company's estimated risk free rate, the product of a company's estimated market beta and the expected market risk premium.

$$COE_{i,t} = R_f + \beta(R_i - R_f)$$

Convectional interbank Interest rate announce by Bank Negara Malaysia is equivalent the risk free rate. In Malaysia, it is commonly known as Base Lending Rate (BLR). The average market returns is calculated based on average percentage (%) of change in the stock price while the companies' market beta will be obtained by regressing all the companies' daily market returns to daily whole market return. Beta is a measure of volatility, or systematic risk, of a security or a portfolio in comparison to the markets as a whole.

Regression Modal

The multiple regression analysis is used to measure the relationship between the cost equity capital and the independent and control variables. The model attempts to capture the factors such as CSR, size of company, liquidity and independent directors that are likely to be important in influencing the cost of equity capital. The Model of this study as follow:

$$\text{COE}_{i,t} = \beta 0_{i,t} - \beta_1 CSR_{i,t} - \beta_2\ SIZE_{i,t} - \beta_3 LIQUIDITY_{i,t} - \text{B}_4\text{INDEPENDENT}_{i,t} + \varepsilon_{i,t}$$

Where:
COE = Cost of equity capital
CSR = corporate social responsibility disclosure
SIZE = natural log of total assets
LIQUIDITY = natural log of current assets
INDEPENDENT = number of independent directors

Results and discussion
Descriptive

Table 1: Descriptive Statistic

	N	Minimum	Maximum	Mean	Std. Deviation
COE	59	-1.53	3.47	.9286	1.28491
CSR	59	1.00	11.00	6.7910	2.38763
SIZE	59	4.53	7.61	5.5505	.51992
LIQUIDITY	59	3.71	7.20	5.2336	.53783
INDEPENDENT	59	.14	.71	.4544	.11056

Table 1 shows the summary of statistic for our sample of 59 companies across the three-year period. COE is measured by using the capital asset pricing model (CAPM). An analysis of Table 4.1 reveals that the average of COE for the sample companies in is 0.929 (range from -1.53 to 3.47) .With regard to corporate social responsibility disclosure (CSR) has an average of 6.691 items disclosed in the annual report. SIZE is measured by natural log of total assets of the companies; the SIZE had an average of 5.551 with minimum of 4.53 and maximum of 7.61. Other control variable which is LIQUIDUTY has mean of 5.234 is calculated by natural log of current assets of the companies. It has minimum value of 3.71 and maximum of 7.20. The last control variable which is the INDEPENDENT has an average of 0.454 which means there is an average of 45% of board independence from its board. The percentage of independent board of directors is equal to total non-executive director divided total directors in board.

Correlation

Table 2: Correlation

		COE	CSR	SIZE	LIQUIDITY	INDEPENDENT
COE	Pearson Correlation					
	Sig. (1-tailed)					
CSR	Pearson Correlation	-.224*				
	Sig. (1-tailed)	.044				
SIZE	Pearson Correlation	-.076	.331**			
	Sig. (1-tailed)	.284	.005			
LIQUIDITY	Pearson Correlation	-.150	.298*	.947**		
	Sig. (1-tailed)	.128	.011	.000		
INDEPENDENT	Pearson Correlation	-.168	.078	.015	-.074	
	Sig. (1-tailed)	.101	.279	.456	.288	

*. Correlation is significant at the 0.05 level (1-tailed).
**. Correlation is significant at the 0.01 level (1-tailed).

Table 2 summarizes the correlation between the independent variables, control variables and the dependent variables. As shown in table 4.2, COE is significantly correlated with CSR at 5% level of significance. The table also showed signs of positive and negative significant correlations among the independent variables and control variables. COE shows a negative but not significant relationship between SIZE, LIQUIDITY, and INDEPENDENT. CSR shows a positive and significant correlation with SIZE and LIQUIDITY at 1% level and

5% level respectively. It also shows positive relationship but not significant with the board independence. The SIZE also shows a significant positive correlation with LIQUIDITY at 1% level and a positive but not significant relationship with INDEPENDENT. LIQUIDITY shows a negative but not significant relationship with INDEPENDENT.

Regression

Table 3: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.411a	.169	.107	1.21409

a. Predictors: (Constant), INDEPENDENT, SIZE, CSR, LIQUIDITY

The table above indicates the influence of CSR together with control variables; SIZE, LIQUIDITY, and INDEPENDENT have a value of R square of 0.169. This indicates that overall test can be explained by CSR and other variables that it has a 16.9% effect the cost of equity capital (COE). Another 82.9% can be explained by other variables do include in this equation.

Table 4: Anova Statistics

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	16.161	4	.040	2.741	.038b
	Residual	79.596	54	1.474		
	Total	95.757	58			

a. Dependent Variable: COE

b. Predictors: (Constant), INDEPENDENT, SIZE, CSR, LIQUIDITY

The ANOVA Statistics for regressions conducted with the control variables in table 4 indicate that the overall regression model was significant because of the reported probabilities were less than the conventional 0.05 (5%) which is 0.038 < p-value. This shows that when all the independent variables and control variables are good joint predictors of dependent variable. Based on ANOVA the F statistics is 2.741.

Table 5: Coefficients of Variables

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	2.499	1.829		1.366	.178
	CSR	-.119	.071	-.222	-1.680	.099
	SIZE	2.349	1.001	.950	2.347	.023
	LIQUIDITY	-2.394	.961	-1.002	-2.491	.016
	INDEPENDENT	-2.784	1.503	-.240	-1.852	.069

a. Dependent Variable: COE
b. Predictors: (Constant), INDEPENDENT, SIZE, CSR, LIQUIDITY

From the table above, there was a negative significant relationship between CSR and COE which t-value is -1.680 and the level of significance at 0.099 (significant at10%). This result is consistent with prior studies made by Dhaliwal et al. (2011), Reverte (2012), Feng et al. (2015), Xu et al. (2015), and Matthiesen and Salzmann (2017). The greater CSR execution reduces general risk of a company being contrarily seen by investors and speculators. High commitment in corporate governance and in precise stringent disclosure standards are resulting a reduction in agency and information asymmetry problems prompts less costly equity financing. Therefore, cost of equity capital is decreased. Most companies disclose info related to goods and clients, workers and civic involvement. CSR disclosures contain little measurable data somehow it is helpful on lowering the cost of capital. Therefore, it can be concluded that the companies listed in Bursa Malaysia with higher corporate social disclosure score enjoy lower cost of equity capital.

There is a positive significant relationship between SIZE and COE which t-value is 2.347 and the level of significance is 0.023 which 0.023 is < p-value 0.05 (significant at 5%).The results show inconsistent with prior studies from El Ghoul et al. (2011) and Hail (2002) which they expect a negative relationship between company size and cost of equity capital. This means the size is not effective in reducing cost of equity capital.

LIQUIDITY has a negative relationship with COE. Table above indicate that LIQUIDITY has a negative significant effect on COE which t-value is -2.491 and the level of significance at 0.016. The decision making of investor’s for investment is influenced by liquidity. Butler et al. (2005) believed that greater liquidity lowers cost of equity capital. The result from this study is consistent with Butler et al. (2005) studies. Since the LIQUIDITY is significant at level 5%, this means that liquidity is effective in lowering cost of equity capital.

Lastly, there is a negative relationship between INDEPENDENT and COE. The table shows the INDEPENDENT has a negative significant relationship between COE which the t-value is -1.852 and the level of significance 0.069 (significant at 10%). Khurana and Raman (2006) stated that satisfaction of investors toward efficiency of board for the job is assessed by investors' required rate of return, which is cost of equity capital. This means that board independence has significant effect on lower cost of equity capital when the number of independent directors increases in board.

Conclusion and Implication of The Study

Overall, most of the prediction made about corporate social responsibility and other variables chosen affecting cost of equity capital are positive. The CSR disclosure is tested in this study has negative significant relationship with the cost of equity capital. This result revealed that cost of equity capital is relatively lower when the index of CSR disclosure is higher because great CSR implementation reduces general risk of a company being rebelliously seen by investors and speculators. The investors and speculators also a benefit from reduced information asymmetry because of higher transparency of information discloses. Therefore, prompts less costly equity financing and cost of equity capital lower. Further, control variables from the results in this study indicated that attributes that are found to significantly influence the cost of equity capital include company size, liquidity and board of independent directors.

There are several important implications of this study. First, this study will contribute to the investors. Investors looking for a core holding that targets stocks with socially responsible characteristics. Investors can get the idea on how CSR disclosure reducing the information asymmetry problems, thus lower systematic risk that can help company to has better stock market performance and lower cost of equity capital. Next, this study will also help managers to gain more competitive advantage from non-financial activities. Managers can get insight from this study on how to enhance incentive for CSR disclosure in annual report for example using a checklist to evaluate a company's CSR efforts and including corporate governance, board diversity, environment, workforce, customer relation, and supply chain. Therefore, the company can enjoy lower cost of equity capital because of the improvement from the CSR disclosure. After that, future studies by academicians will also have a guideline to explore further. Academicians can also lead to new opportunities and explore more new area and extent the research. Researchers cannot always anticipate what the results of their research will be. Therefore, after this study, there will be more new channels of research which is based on this study.

Acknowledgements

This research gratefully acknowledges the assistance of Universiti Malaysia Sarawak by giving Research Acculturation Grant Scheme [RAGS/SS01 (2)/1309/2015(3)].

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Appendix

Summary of the Major Element of Disclosure

	I. Environmental Management
1.	Paying attention to environment protection, consistent standards around the globe.
2.	Active engagement in promoting environmental awareness.
3.	Energy saving / reduce carbon.
4.	Availability of the awareness of and strategies for sustainable development.
	II. Product Quality Control
1.	Strengthening product quality control at all times to provide qualified products.
	III. Employee protection
1.	Sufficient social security and insurance for employees.
2.	Training, cultivation of local technical and managerial human resource.
	IV. Sound Corporate Image
1.	Availability of corporate culture that highly emphasizes social responsibility.
2.	Adequacy of information communication and disclosure mechanisms.
3.	Donation to community group and charitable bodies.
4.	Sponsoring communities programs and activities.