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THE ROLES OF COST OF CAPITAL, CORPORATE GOVERNANCE, AND CORPORATE SOCIAL RESPONSIBILITY IN IMPROVING FIRM VALUE: EVIDENCE FROM INDONESIA

Abstract

Corporate governance (CG) and corporate social responsibility (CSR) are important subjects for corporate sustainability that affect firm value (FV). At the same time research results in several countries provide diverse empirical evidence. This study analyzes the impact of corporate governance (CG) and corporate social responsibility (CSR) on firm value (FV) through the cost of capital (CoC) in public companies of Indonesia. The research sample includes 27 companies that publish sustainability reports and corporate governance reports, with an observation period from 2010 till 2016. This study presents the analysis of three firm value proxies (Tobin's q (TQ), Price Earnings Ratio (PER), and Price to Book Value (PBV)). Results of hypotheses testing using Partial Least Squares (PLS) show that CG and CSR have both direct and indirect effects on FV. These findings are consistent for all three firm value assessments. According to direct testing, CG has a negative effect on FV, while CSR has a positive effect. The CoC acts as a mediating variable in this relationship. The CG and CSR have a negative effect on CoC, while CoC has a negative effect on FV. The findings show that CG and CSR can improve the company performance and corporate image internally and externally, thereby increasing the investors' confidence, and companies have the opportunity to obtain inexpensive funding sources that can reduce CoC. A decrease in CoC can increase profitability and have an impact on FV increasing.

Keywords cost of capital, profitability, performance

JEL Classification G32, G34

INTRODUCTION

FV is reflected in stock price and represents the investor's perception of companies (Fama, 1978). The development of companies' stock prices on the Indonesia Stock Exchange (IDX) has implemented CG and CSR, which fluctuated between 2009 and 2016 (Figure 1). Furthermore, cases of declining stock prices followed by declining FV and delisting were experienced by several companies with issue corporate sustainability. Thus, the problem of corporate sustainability is an important matter and should be a serious concern for the company. CG and CSR are things that must be carried out by companies seriously and comprehensively to achieve sustainability. Implementation of CG and CSR can improve company performance and company stakeholder satisfaction, thereby impacting investor confidence which increases FV and guarantees the company's sustainability.

Companies' main goals are maximizing FV and shareholder wealth (Salvatore, 2005; Bowman & Ambrosini, 2007; Brigham & Houston,

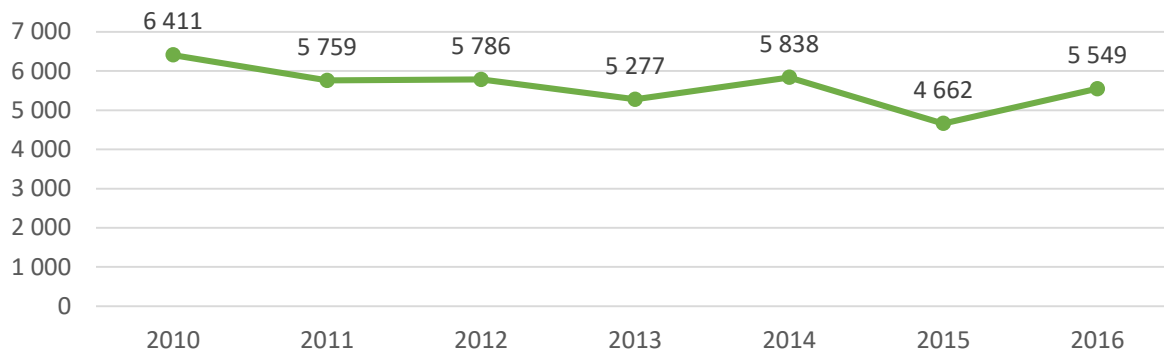


Figure 1. Average Share Prices of Companies has implemented CG and CSR

2011). Jensen and Meckling (1976) stated that companies should consider not only equity values, but also all companies' financial claims to maximize firm value. Companies can maximize firm value through a financial management function (Fama, 1978). The investment function of corporate finance is a strategic financial management function. Corporate finance decisions are related to the selection and determination of the optimum capital mix (i.e., a combination of various types of capital with the lowest CoC. Management must continuously seek a minimum CoC and ensure that the profit rate is above the CoC (Gitman, 2000). Management strategy is needed to reduce the CoC. It can be done by implementing CG and ethical behavior to improve the company performance and corporate image to increase FV. These activities are known as CG and CSR.

CG implementation will improve the company's financial performance, increase investor confidence, and ultimately increase firm value (Singhal, 2014). Companies control the agency problem efficiently through internal devices (such as corporate governance structures) (Fama, 1980). Whereas, according to the stakeholder theory, companies must be managed for their stakeholders' interests to achieve sustainability (Freeman, 2001). Companies do not only fulfill obligations to shareholders but also to stakeholders (Freeman, 2001). Legitimacy theory states that the company's survival also depends on the company's relationship with the community and the environment in which the companies operate (Haniffa & Cooke, 2005).

Several previous studies provide empirical evidence that CG increases FV (Huang, 2010; Connelly et al., 2012; Nur'ainy et al., 2013; Villanueva-Villar et al., 2016), and CSR increases FV (Jang et al., 2013; Usman & Amran, 2015; F. Li, T. Li, & Minor, 2016). However, several studies show different results, suggesting that CG reduces FV (Berthelot et al., 2012; Zabri et al., 2015), as does CSR (Aras et al., 2010; Liu & Zhang, 2016). The research on the relationships between CG and the CoC, as well as the relationship between CSR and the CoC, show that CG reduces the CoC (Chen et al., 2009; Ramly, 2012; Gomes, 2014), as does CSR (Dhaliwal et al., 2014; Li & Foo, 2015).

This study examines the effects of CG and CSR on FV through the CoC. CG and CSR increase investor confidence in companies by providing investment security, along with the improvement of company performance and corporate sustainability, which enhance the corporate image as a sign of investment security. Investment security will provide opportunities for companies to obtain inexpensive funding sources and eventually lower the cost of capital. This is in line with agency theory that corporate governance mechanisms reduce information asymmetry and agency conflict, thereby, increasing investor confidence. Economic, environmental, and social management carried out through CSR programs show corporate responsibility to stakeholders and gain the legitimacy of the community in the company's operations. This research has a theoretical contribution related to the importance of CG and CSR mechanisms in reducing the CoC, increasing the profitability, and the impact of increasing FV.

1. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

A company's main goal is to provide shareholder wealth (Brigham & Daves, 2011). Momentary wealth is certainly not expected, but the focus is on long-term wealth reflected by high FV. According to agency theory, a potential conflict of interest occurs when company management is handed over by the owner to the management (Jensen, 1993). The management is required to implement the CG principle to achieve the company's goals.

Ammann et al. (2011) observed the firms in 20 developed countries and Lozano et al. (2016) examined the firms in 16 European countries and both provided empirical evidence that CG increases FV. The same results were shown by Li et al. (2012) in 308 companies in Russia from 2002 till 2009; and Ararat et al. (2017) in Turkey from 2006 till 2012. Yet different results were found by Jo and Harjoto (2011) in companies in the United States from 1993 till 2004, Berthelot et al. (2012) in 199 companies in Canada from 2004 till 2005 with 355 observations, and Kumar and Singh (2013) in 176 Indian companies. As CG helps to overcome various agency problems, the CG implementation affects FV. We hypothesize the following:

H1: Corporate Governance has an effect on Firm Value positively.

Companies should prioritize all stakeholders' interests, behave ethically in conducting the business activities, gain social legitimacy to achieve sustainability, and gain investor confidence to increase firm value. Elkington (1997) stated that a good company does not only pursue economic benefits but also has a concern for environmental sustainability and public welfare.

Jo and Harjoto (2011) observed the US companies from 1993 till 2004 and found that CSR increases FV. Similar results were found by Jang et al. (2013) in 130 Korean companies from 1998 till 2005. Li et al. (2016) who examined 2,944 companies in a KLD stats database from 1998 till 2013 also found similar results. Different results were obtained by Aras et al. (2010) in Turkey, Liu and Zhang (2016)

in China, and Becchetti et al. (2012) in the Domini 400 Social Index. Crisostomo et al. (2011) observed 78 companies in Brazil from 2001 till 2006, and Liu and Zhang (2016) who examined 77 industrial companies with heavy pollution in China from 2008 till 2014 also found different results.

As CSR makes companies more accountable to stakeholders, we assume that the corporate social responsibility implementation affects FV. Therefore, we hypothesize the following:

H2: Corporate Social Responsibility has an effect on Firm Value positively.

An increase in FV can be achieved through a decrease in the CoC (Brigham & Daves, 2011). Indeed, management will always seek low CoC (Gitman et al., 2006). Sattar (2015) who examined textile companies in the KSE 100 Index from 2004 till 2012 found that a decrease in the CoC increases FV. CG and CSR are important to reduce the CoC.

Moreover, CG implementation reduces information asymmetry and increases investor confidence in the company's fund management, thereby reducing monitoring costs and expected rates of return. Research by Byun et al. (2008) in Korea from 2001 till 2004 with 478 total observations found that sound CG practices reduce agency problems and information asymmetry and reduced the CoC. Similar results were also found by Ramly (2012) in public companies in Malaysia from 2003 till 2007, and Gomes (2014) who studied 42 registered companies in Portugal from 2011 till 2012.

Furthermore, with CSR implementation, companies have prioritized stakeholders and gained social legitimacy. Corporate sustainability is maintained and increases the stock investor and creditor confidence, reducing investment risk and the CoC. Research by Dhaliwal et al. (2014) of 1,093 firms in 31 countries from 1995 till 2007 found that CSR implementation can reduce the CoC. These results are consistent with Ge and Liu (2015) who examined 4,260 public firms in the US and Li and Foo (2015) in 1,015 companies in China.

The implementation of CG and CSR increases investor confidence in company's fund management, investment security, corporate sustainability, and

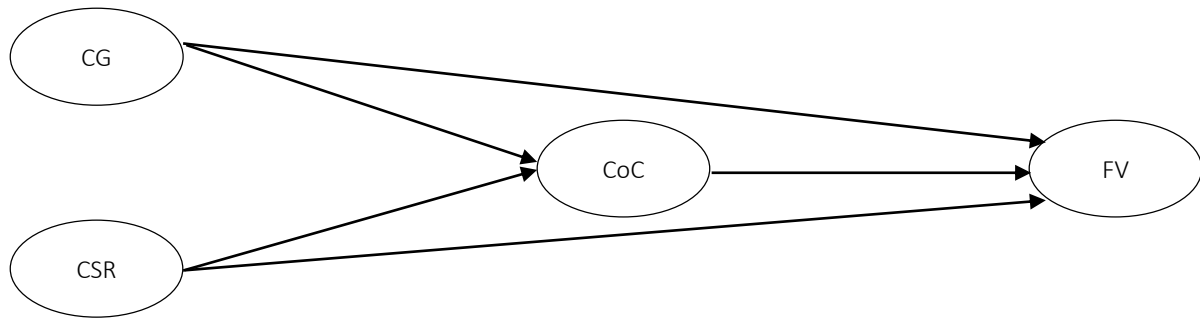


Figure 2. Research model

reduced investment risk. Company management as an “agent” for shareholders and creditors will act with full awareness wisely and thoughtfully in managing the company. Company activity is a source of information for external stakeholders in the decision to allocate their resources to the company (Mahon, 2002).

Good implementation of CG and CSR has an indirect effect on FV. We assume that companies apply it indirectly through opportunities to obtain cheap funding sources, which may increase their firm value over other companies. Thus, we hypothesize the following:

H3: Corporate Governance has a positive effect on Firm Value mediated by the Cost of Capital.

H4: Corporate Social Responsibility has a positive effect on Firm Value mediated by the Cost of Capital.

The research model is presented in Figure 1.

2. METHODS

Firm value for the main analysis was measured by Tobin’s q , developed by Chung and Pruitt (1994). Tobin’s q is the ratio of the market value of a company’s assets as measured by the market value of the number of shares outstanding and the debt of the company’s assets. To measure the sensitivity of the results, the FV was measured using PER and PBV. PER is a ratio that shows the level of annual profit of the company against the current stock price, whereas PBV is an investment valuation ratio that is often used by investors to compare the market value of a company’s stock with its book

value. Corporate governance (CG) is a set of mechanisms used to regulate the relationships of all company stakeholders so that the company is well managed to safeguard the interests of shareholders. The measurement of CG uses the Corporate Governance Score, developed by Siagian et al. (2013). The CG Score includes five sub-indexes, namely, CG measured using Right of shareholders (RioS), Equal treatment of shareholders (EToS), Role of stakeholders (RoS), Disclosure and transparency (D&T), and Responsibility of the board (RoB). Assessment begins with the content analysis dichotomous approach, that is, each CG item in the research instrument is given a value of 1 if it is run by the company and 0 if it is not executed. A checklist is carried out on the CG report. Furthermore, the CG Score is the percentage of elements that are executed.

Corporate social responsibility is the commitment of the business community to be accountable to all stakeholders by conducting their business ethically to achieve the prosperity of stockholders and achieving business sustainability in the long run. In this study, CSR is proxied by corporate social responsibility indices (CSRI) published in the company’s sustainability report (SR). The CSRI focuses on economic (EC), environmental (ENV), and social (SOC) management. The measurements of CSRI use a dichotomy approach, in which each item in the instrument is given a value of 1 if it has been run by the company and 0 if it has not been executed (Haniffa & Cooke, 2005). The checklist is carried out on the company’s sustainability report, which has been prepared based on the GRI and has issued a GRI cross-reference. Furthermore, the CSRI is the percentage of instruments that are carried out. The cost of capital is the weighted average of all funding from debt and equity capital to fund investment or company op-

erations. The measurement of CoC is proxied by the WACC (weighted average of the cost of capital) (Modigliani & Miller, 1958).

The research population includes all companies going public on the Indonesia Stock Exchange (IDX), whose shares were actively traded in the 2010–2016 period, issuing sustainability reports with GRI cross-references, and publishing CG reports. All populations that met the criteria are used as research samples. Our sample consisted of 27 companies that compiled SR and CG reports presented in Table 1. The nature of reporting was voluntary and not all companies gave a report for each period. Thus, the research data include unbalanced panel data.

Table 1. Sample selection

Explanation	Total/ Firm-year
Total firms issuing SR in 2016	48
Total firms issuing SR in 2010–2016 with missing data of more than 20%	(21)
Total firms issuing SR in 2010–2016 with a maximum missing data of 20%	27
Total observations	189

This study has used a PLS approach to test the hypotheses. We present a path model for all latent variables in PLS, which consisted of two elements: the outer model and inner model to test the indicator measurement model and structural model. Furthermore, the models built in this research are comprised of three models aiming to test the sensitivity level of FV measurements.

3. RESULTS AND DISCUSSION

The mean of TQ, PER, and PBV are 1.6491, 22.2256, and 2.3762, respectively, with high standard deviations (0.89070, 18.92453, and 1.29456). It shows that TQ, PER, and PBV in our sample companies vary greatly. The mean of the CG score is above 0.75, with relatively low variation (standard deviation ranges from 0.06801 to 0.12978). The mean of the CSR index is above 0.5, with relatively low variation (standard deviation of 0.27871 for economic management, 0.34351 for environmental management, and 0.30486 for social management). The mean of the CoC is 0.05677, with an SD of 0.08188 (low).

Table 2. Descriptive statistics

Variable	Max.	Min.	Mean	SD
TQ	5.32	.59	1.6491	.89070
PER	98.54	.25	22.2256	18.92453
PBV	8.31	.05	2.3762	1.39456
RioS	1.00	.50	.9126	.12978
EToS	1.00	.50	.7831	.10265
RoS	1.00	.75	.8138	.10901
D&T	.93	.63	.8025	.06801
RoB	.89	.55	.7679	.07730
EC	1.00	.11	.6787	.27871
ENV	1.00	.03	.5292	.34351
SOC	1.00	.08	.5454	.30486
CoC	.21	.02	.05677	.08188

The outer model testings presented in Table 3. This research used a formative indicator measurement model for all variables. All variables used in this research met p-value and VIF less than 0.05 and 5, thus the formative construct measurement is considered feasible.

The inner model test is presented in Table 4 to ensure that structural models are robust and accurate. Panel A presents the model's goodness-of-fit test and shows that all tests are met for all models. Thus, the model is good and can be used to explain the phenomenon under study and can be used to test the hypotheses. The CoC, CG, and the CSR variables have predictive relevance for the FV variable. Panel B shows the R^2 of FV in Model 1 is 0.307, in Model 2 is 0.208, and in Model 3 is 0.245, while R^2 of the CoC is 0.071. This means that the values meet the requirements to be examined in the next process. Panel C of Table 4 shows that predictive relevance in Model 1 is 0.3562, in Model 2 is 0.2642, and in Model 3 is 0.2986. The Q^2 value greater than zero indicates that the CoC, CG, and the CSR variables have predictive relevance for the FV variable.

Next, to test the hypotheses, we conducted a path analysis with the PLS presented in Table 5. Consistent with all hypotheses, we found that CG and CSR have a direct and indirect effect on FV through the CoC. These results are consistent for all FV measurement models. Our *HI* test result shows the CG has a negative effect on FV. The explanations for this result are, first, the sharehold-

Table 3. Indicator measurement model test results

Variable	CG	CSR	CoC	TQ	PER	PBV	Type	P-value	VIF
CG	RioS	0.379	0	0	0	0	Formative	<0.001	1.314
	EToS	0.358	0	0	0	0	Formative	<0.001	1.337
	RoS	0.139	0	0	0	0	Formative	0.025	1.107
	D&T	0.308	0	0	0	0	Formative	<0.001	1.224
	RoB	0.47	0	0	0	0	Formative	<0.001	1.403
CSR	EC	0	0.355	0	0	0	Formative	<0.001	3.595
	ENV	0	0.353	0	0	0	Formative	<0.001	3.367
	SOC	0	0.361	0	0	0	Formative	<0.001	4.38
CoC	0	0	1	0	0	0	Formative	<0.001	0
TQ	0	0	0	1	0	0	Formative	<0.001	0
PER	0	0	0	0	1	0	Formative	<0.001	0
PBV	0	0	0	0	0	1	Formative	<0.001	0

Table 4. Structural model analysis

		Model 1	Model 2	Model 3	Explanation
Panel A. Model's goodness-of-fit test					
1	APC	0.246; sig. < 0.001	0.212; sig. < 0.001	0.223; sig. < 0.001	Good
2	ARS	0.189; sig. 0.002	0.140; sig. 0.012	0.158; sig. 0.007	Good
3	AARS	0.178; sig. 0.003	0.128; sig. 0.013	0.147; sig. 0.010	Good
4	AVIF	1.011	1.010	1.008	Good
5	AFVIF	1.167	1.110	1.100	Good
6	GoF	0.389	0.335	0.356	Good
7	SPR	1.000	1.000	1.000	Ideal
8	RSCR	1.000	1.000	1.000	Ideal
9	SSR	1.000	1.000	1.000	Good
10	NLBCCR	1.000	0.900	1.000	Good
Panel B. Coefficient of determination (R²) test					
Firm value		0.307	0.208	0.245	Feasible
Cost of capital		0.071	0.071	0.071	Feasible
Panel C. Predictive relevance (Q²)					
		0.3562	0.2642	0.2986	Relevance

Notes: Model 1 – FV measured using Tobin's q, Model 2 – FV measured using PER, and Model 3 – FV measured using PBV.

Table 5. Path analysis

Path	Model 1		Model 2		Model 3	
	Path coef.	Sign.	Path coef.	Sign.	Path coef.	Sign.
CG → FV	-0.23	< 0.01	-0.13	0.04	-0.12	0.04
CSR → FV	0.38	< 0.01	0.32	< 0.01	0.29	< 0.01
CoC → FV	-0.26	< 0.01	-0.25	< 0.01	-0.34	< 0.01
CG → CoC	-0.21	< 0.01	-0.21	< 0.01	-0.21	< 0.01
CSR → CoC	-0.15	0.02	-0.15	0.02	-0.15	0.02
CG → CoC → FV	0.053	0.02	-0.052	0.02	0.071	0.01
CSR → CoC → FV	0.039	0.064	0.038	0.06	0.051	0.05

ers doubt the CG quality used to protect their interests better. Consequently, the investors consider that good CG practice is not a factor which can be used as a consideration in appreciating firm value. Second, the companies have not implemented CG comprehensively, causing its benefits to have not been felt for increasing firm value. CG and FV are only seen when implemented in comprehensive actions, not selective and narrow actions, in line with Connelly et al. (2012).

H2 test result show the CSR has a positive effect on FV. The economic, environmental, and social management give indirect benefits to the companies (i.e., an increase in consumer confidence for the companies' products and a demand for the companies' shares by investors in line with increased investor confidence in the companies' sustainability and investment security). This is in line with Elkington's (1997) statement that companies should be accountable to all stakeholders.

H3 and *H4* test results show the CoC proved to be mediation variable. An increase in CG and CSR reduces the CoC and further increases FV. CG run by companies causes better decision-making and produces optimal decisions. It will improve efficiency and healthier work culture. CSR activities are corporate responsibility to all stakeholders to enhance a positive corporate image in the public. CSR activities related to employees

increase work motivation to improve the company's performance. The implementation of CG and CSR enhances company's performance and positive corporate image internally and externally. Furthermore, the implementation increases investor confidence and creates positive references to investors, so that companies have the opportunity to obtain inexpensive funding costs from creditors and stock investors. CG and CSR encourage companies to make a rate of return outweigh the CoC, thereby increasing FV.

These research results provide theoretical implications that low CoC to increase FV can be achieved by companies with the implementation of CG and CSR. Against the agency theory, this research has implications in explaining the phenomenon of FV, extending the explanation of agency conflict control through CG implementation, which increases investor confidence in the company's fund management. Increased confidence will reduce monitoring costs and expected rates of return on investments, thus, reducing the CoC and increasing FV. Furthermore, this research also gives implications for the legitimacy and stakeholder theories in explaining the phenomenon of FV (i.e., to expand the corporate responsibility theory to achieve sustainable development). CSR carried out by companies guarantees that corporate sustainability reduces investment risk and increases investor confidence, thus, reducing the CoC and increasing FV.

CONCLUSION

This study examines the effect of CG and CSR implementation for the period 2010–2016 on the FV and the role of capital costs as a mediating variable of the companies listed on the Indonesia Stock Exchange. It finds significant CG and CSR have effects on FV, and the results are consistent for all FV proxies. Interesting findings from this research are that CG has a negative immediate effect on FV, while CSR has a positive immediate effect. We also found that the CoC acts as a mediating variable in this relationship. Overall, this study finds that the CG and CSR increase significantly affect the FV. It also finds significant the role of CoC mediation, namely CG and CSR reducing CoC and increasing FV.

The implementation of CG and CSR can improve positive corporate image internally and externally, thereby, increase investor confidence. Investor confidence is an opportunity for companies to obtain inexpensive funding sources, so they can reduce the CoC, thus, increasing profitability and subsequently increasing FV. Future research can group by type of company and examine how it affects the cost of corporate capital. This study provides policy recommendations to the Indonesian government, namely, CG and CSR reporting to be mandatory with a standard reporting format.

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