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## The Effect of Sustainability Report on Financial Performance with Good Corporate Governance Quality as a Moderating Variable

Sarita Vania Clarissa<sup>a</sup>, Ni Ketut Rasmini<sup>b\*</sup>

<sup>a,b</sup>*Department of Accounting Udayana University, Denpasar, Indonesia*

<sup>a</sup>*Email: vaniapremire@gmail.com*

<sup>b</sup>*Email: tut\_ras@yahoo.com*

### Abstract

Financial performance is an important issue for company. Currently, one of method that can be used to improve financial performance is disclose sustainability report. Sustainability report is a report containing non-financial information that consists economic, social and environment performance. Sustainable companies is a company that not only pay attention to the benefits, but also aware about environment and social around their company. To create effective and efficient sustainability report, require a good corporate governance. This study analyzes the effect of sustainability report on financial performance by observe at each aspect of the sustainability report and to analyze how good corporate governance quality can moderate that effect. This study use financial company who publish sustainability report on 2013-2016 and participated in Corporate Governance Perception Index (CGPI) as a sample. The method used to analyse the effect between variables is Moderated Regression Analysis. The results of this study indicate that social and environment performance disclosure has positif significant effect on financial performance, but economic performance disclosure has negative significant effect on financial performance. Good corporate governance quality weakens the effect of economic and environment performance disclosure on financial performance. But good corporate governance quality is not able to moderate the effect of social performance disclosure on financial performance.

**Keywords:** Financial Performance; Good Corporate Governance Quality; Sustainability Report.

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\* Corresponding author.

## **1. Introduction**

Good or bad financial performance can be seen from the financial statements. But in fact, just looking at the financial statements is not enough to judge a company's performance. Phenomenon of bankruptcy Lehman Brother in September 2008 became one of triggers global economic crisis. Another phenomenon, where 8 Banks and Financial Institutions in Indonesia do not consider the aspect of environment in giving credit. This shows that the company's financial performance is not only seen from the figures listed in the financial statements. But there are other factors can affect company performance, such as how the company acts on the environment or social. Thus, another report is required to present the overall condition of the company. One of the disclosures that can be used by the company is sustainability report. Sustainability report is a report that contains financial performance information and non-financial information that consists social and environment activities enabling companies to grow sustainably (sustainable performance) [6]. If a company wants to maintain its survival, company should pay attention to "3P". That is, besides pursuing profit (profit), the company should also pay attention to and engage in the fulfillment of people's welfare (people) and contribute actively in preserve the environment (planet) [6]. Based on the theory of legitimacy, encourage companies to ensure that activities and performance are acceptable to society [3]. Company use sustainability report to illustrate the impression of responsibility for the economy, social and environment, so that the company can be accepted by the society. In addition to the theory of legitimacy, this research is also supported by the existence of stakeholder theory. A company is not an entity that only operates for its own sake, it must also provide benefits to its stakeholders [8]. So it will improve the company's image and also will improve the company's financial performance. Some research proves that sustainability reports affect financial performance such as research from the author in [23] state that sustainability has a positive and significant impact on financial performance in the UK and India. Companies in Malaysia that issue sustainability [22]. Sustainability report disclosures positively affect the company's financial performance as measured by ROA [24]. The same results were also shown by author in [27] which stated that sustainability affects financial performance in the long run. Different results found by the author in [25] which find that sustainability report disclosure does not affect financial performance as measured by ROA and DER. The author in [26] also stated that aspects of sustainability report negatively affect the company's financial performance. That differences, expected due to other factors that may affect the sustainability report on financial performance. One other factor that can affect is good corporate governance quality. Sustainability reports makes the company bear additional costs that will decrease the company's earnings [15]. As a way to improve performance, the company will depends on executive autonomy and corporate governance to monitor and control sustainability report activities with efficient decision making. Good corporate governance quality in this research is the quality or level of good or bad of a company in implementing the principles of good corporate governance as measured by Corporate Governance Perception Index (CGPI).

## **2. Theoretical review**

**Legitimacy Theory.** The theory of legitimacy offers a mechanism for understanding social and environment disclosures made by companies [19]. Legitimacy theory is a theory that assumes companies are trying to ensure that the operations they run are already under existing social rules and norms [3]. When the public realizes that

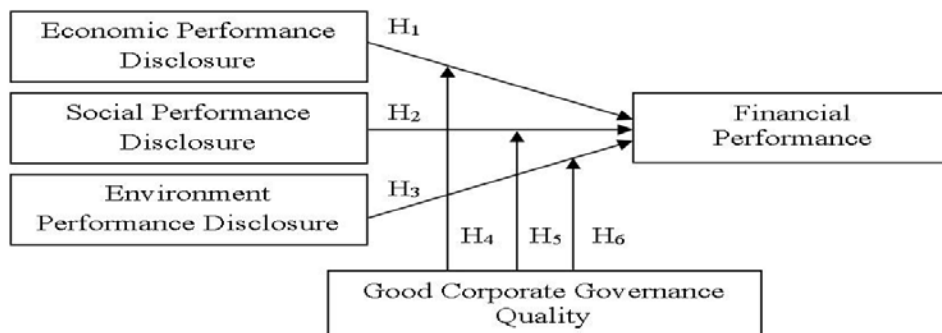
company operates for a value system commensurate with the value system of the society itself so company will continue its existence. The company uses a sustainability report to illustrate the impression of responsibility for the economy, social and environment, so that the company is accepted by the society. With the acceptance of the society, company expected to improve their performance and it will also increase corporate profits.

**Stakeholder Theory.** Stakeholders theory is a theory that describes to whichever company is responsible [8]. Stakeholder theory assumes that a company is not an entities that operate only for the benefit of shareholders but must also provide benefits to stakeholders. By disclosing the sustainability report, the company discloses financial information and non-financial information, enabling companies to more transparently communicate with the public about their business activities related to non-financial management and performance aspects.

**Financial Performance.** Financial performance is a description of the company's financial condition during the period concerning fund raising and fund distribution aspects, as measured by capital coverage, liquidity, and profitability indicators [11]. Financial performance can be reflected through the analysis of financial ratios of a company, one of the measurement of financial performance is profitability. Profitability is the most important thing in a company.

**Sustainability Report.** is a report that contains financial information and non-financial information that consist social and environment activities enabling the company to grow on an ongoing basis [6]. Sustainability report consists of 3 aspects: economic performance disclosure, social performance disclosure and environment performance disclosure.

**Good Corporate Governance Quality.** Good Corporate Governance Quality in this study is the quality or level of good or bad a company in implementing or implement the principles of good corporate governance. In many countries there are a variety of measurement models for measuring good corporate governance quality, such as seecgan indexes used in Eastern European countries [5], and there are also WHK Howart measures that rank to measure the quality of corporate governance in Australia [1]. While in Indonesia, good corporate governance quality measurements can be obtained from the survey results of The Indonesian Institute of Corporate Governance (IICG) i.e Corporate Governance Perception Index (CGPI) [17,13,20,14].



**Figure 1:** Theoretical Framework

Based on the framework, the hypothesis proposed in this study as follows:

H<sub>1</sub>: Economic Performance Disclosure has an effect on company's financial performance

H<sub>2</sub>: Social Performance Disclosure has an effect on company's financial performance

H<sub>3</sub>: Environment Performance Disclosure has an effect on company's financial performance

H<sub>4</sub>: Good Corporate Governance Quality moderates the effect of economic performance disclosure on financial performance.

H<sub>5</sub>: Good Corporate Governance Quality moderates the effect of social performance disclosure on financial performance.

H<sub>6</sub>: Good Corporate Governance Quality moderates the effect of environment performance disclosure on financial performance.

**3. Research methods**

The population in this study are all financial sector companies in Indonesia during 2013-2016. Sample selection method used is purposive sampling method, with the following sample criteria: (1) Corporate that participated in Corporate Governance Perception Index (CGPI); (2) Company had published its financial statements from 2013-2016; (3) The Company had established and published Sustainability Report from 2013-2016; (4) Financial report data, Corporate Governance Perception Index (CGPI) and sustainability report are fully available from 2013 to 2016. The method used to analyse the effect between variables is Moderated Regression Analysis.

**4. Result and discussions**

In this study, hypothesis testing using 3 times testing. Test 1 is conducted to examine the economic, social and environment performance disclosure effects on financial performance, presented in the following equation:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \epsilon_1 \dots\dots\dots(1)$$

Tests 2 and 3 were conducted to examine the effect of moderation on good corporate governance quality on economic, social and environment performance disclosure on financial performance and to see qualification of moderation variables, presented in the following equation:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 Z + \epsilon_2 \dots\dots\dots(2)$$

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 Z + \beta_5 X_1 * Z + \beta_6 X_2 * Z + \beta_7 X_3 * Z + \epsilon_2 \dots\dots\dots(3)$$

Y = Financial Performance

X<sub>1</sub> = Economic Performance Disclosure

X2 = Social Performance Disclosure

X3 = Environment Performance Disclosure

Z = Good Corporate Governance Quality

$\alpha$  = Constanta

$\beta$  = Regression Coefficient

$\varepsilon$  = Error

Hypothesis testing variables are presented in tables 1, 2, and 3:

### **The Effect of Economic Performance Disclosure on Financial Performance**

Based on table 1, the regression coefficient of economic performance disclosure is -0.185 with significance value 0.007 (<0.05) which means H0 is rejected and H1 accepted. This means economic performance disclosure negatively affect the financial performance, The lower the company's financial performance, the higher the company discloses its economic performance in sustainability report.

Economic performance disclosure is a disclosure of information related to the impact of company on the economic situation of its stakeholders and on the domestic, national and global economic system [9]. The existence of a negative influence between economic performance disclosure and financial performance is consistent with the hypothesis of management opportunism. Managerial opportunistic is a condition where managers advise to reduce spending on social performance to improve short-term profitability and management compensation. But when financial performance is poor, management diverts attention to sustainability report [15]. So, companies that have poor financial performance in this case low profitability tend to reveal more information about economic performance to distract shareholder and stakeholders from poor financial performance. This is in line with financial performance data and economic disclosures in this study sample where companies with relatively low financial performance compared with other financial firms, but reveal more economic performance.

### **The Effect of Social Performance Disclosure on Financial Performance**

Based on table 1, the regression coefficient of social performance disclosure variable is 0.772 with a significance value 0.000 (<0.05) which means H0 is rejected and H2 accepted, which means that social performance disclosure has a positive significant effect on financial performance. It shows that the higher the company's financial performance, the higher the company discloses its social performance in sustainability report.

Social performance disclosure is a disclosure of information relating to the impact the company has on the social system around companies [9]. Economic performance explains the risk of interaction with other social

institutions that they manage. The company's concern in anticipating society related issues such as corruption, public policy, anti-competitive such as anti trust and monopoly. The disclosure of sustainability report on social performance aspects will impact stakeholder perceptions about the company's treatment of the surrounding human resources. [18]. By implementing and reporting social responsibility to the stakeholders, not only can increase the company's average stock price but improve employee welfare and loyalty, lower employee turnover so that it can lead to increased productivity of the company which can also increase profitability [7].

The results consistent with legitimacy theory, company will continue to exist if the society realizes that company operates for a value system commensurate with the value system of the society itself. Companies use sustainability reports to illustrate the impression that companies are aware of the society. In addition, the results of this study are also consistent stakeholder theory, which assumes that a company is not an entity that operates only for the benefit of shareholders but must also provide benefits to stakeholders. These results are consistent with the social impact hypothesis which suggests that comply the stakeholders needs will have a positive impact on financial performance.

**The Effect of Environment Performance Disclosure on Financial Performance**

Based on table 1, the regression coefficient of environment performance disclosure variable is 0,351 with significance value 0,011 (<0,05) which mean H0 is rejected and H3 accepted, which means that environment performance disclosure have positive effect on financial performance. This indicates that the higher the company's financial performance, the higher the company discloses its environment performance in sustainability report.

**Table 1:** Regression Analysis Results Equation 1

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
1(Constant)	-,004	,038		-,103	,919
Economics(X1)	-,185	,064	-,185	-2,907	,007
Social (X2)	,772	,153	,771	5,053	,000
Environment (X3)	,351	,129	,350	2,709	,011

Environment performance disclosure is a disclosure of information relating to organizational impact on living and non-living natural systems, including land, air, water and ecosystems [9]. Disclosure of environment performance is important to show the existence and participation of companies in handling environment issues. Companies need to demonstrate the existence and participation in handling of environment issues as a form of corporate responsibility morally to environment around company which is consistent with legitimacy theory. The company's ability to communicate environment activities to corporate stakeholders is important to enhance

the reputation and trust of stakeholders, including consumers that can lead to increased corporate earnings [7]. Companies that disclose environment performance in sustainability reports, show that companies are aware of the environment and are aware of the company's environment responsibilities such as saving energy, water and materials consumption.

The result of this research are consistent with stakeholder theory, which assumes that a company is not an entities that operate only for the benefit of shareholders but must also provide benefits to stakeholders. These results also consistent with the social impact hypothesis which suggests that comply the stakeholders needs will have a positive impact on financial performance. This indicates that the financial firms in this study do not consider the disclosure of environment performance as a burden, but rather as an opportunity improving the performance of the company.

**Table 2:** Regression Analysis Results Equation 2

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error			
1(Constant)	-,003	,033		-,099	,922
Economics(X1)	-,212	,056	-,212	-3,762	,001
Social (X2)	,843	,136	,841	6,210	,000
Environment (X3)	,278	,116	,278	2,409	,022
GCG Quality (Z)	,110	,034	,110	3,220	,003

**The Effect of Good Corporate Governance Quality on The Effect of Economic Performance Disclosure on Financial Performance**

Based on table 3, the moderation coefficient of good corporate governance quality on the effect of economic performance disclosure on financial performance is 0.260 with a significance value 0.017 (<0.05) which means H0 rejected and H4 accepted, which means that good corporate governance quality weakens the effect of economic performance disclosure on financial performance.

The negative influence of economic performance disclosure on financial performance is due to the opportunistic manager. Managerial opportunistic is a condition where managers advise to reduce spending on social performance to improve short-term profitability and management compensation. But when financial performance is poor, management diverts attention to sustainability report [15]. So companies that have poor financial performance in this case low profitability tend to reveal more informantion about economic

performance to distract shareholder and stakeholders from poor financial performance.

Corporate governance is a mechanism for disciplining management in taking the most appropriate decisions [2]. Companies with good corporate governance quality should have an effective and efficient supervisory mechanism. The results of this study show that the better the quality of corporate governance will decrease opportunistic managers.

**Table 3:** Regression Analysis Results Equation 1

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
1(Constant)	,047	,042		1,122	,272
Economics(X1)	-,166	,051	-,166	-3,254	,003
Social(X2)	,730	,122	,728	5,958	,000
Environment(X3)	,346	,104	,346	3,343	,002
GCG Quality(Z)	,169	,035	,169	4,784	,000
M1	,260	,102	,148	2,549	,017
M2	,217	,216	,081	1,001	,326
M3	-,644	,266	-,161	-2,419	,023

The results of this study support instrumental stakeholder theory that the board of corporations should be responsible for organizing the organization's mission and strategy to achieve it. This suggests that the board of corporations should be the primary responsible for designing, implementing and enhancing the company's contribution to sustainable development and human well-being [10].

These results are consistent with the author in [10] suggesting that CSR strategy choices are positively related to the characteristics of corporate governance. The positive impact of CSR on financial performance could be facilitated by setting up the right corporate governance mechanism [12]. Another author in [21] also found that corporate governance moderates CSR and corporate performance. In addition, environment activities carried out by companies can create additional costs and benefits which can ultimately affect the company's financial performance. The benefits gained bring competitive advantage and enhance the company's image [16].

**The Effect of Good Corporate Governance Quality on The Effect of Social Performance Disclosure on**



## **Financial Performance**

Based on table 3, the moderation coefficient of good corporate governance quality on the effect of social performance disclosure on financial performance is 0.217 with a significance value 0.326 ( $> 0.05$ ) which means  $H_0$  accepted and  $H_5$  rejected. This indicates that good corporate governance quality does not moderate influence social performance disclosure on financial performance. This means that social performance in sustainability report disclosed by companies with good corporate governance quality can not affect financial performance.

Based on existing data, shows that financial companies that have trusted corporate governance aware with the company's social performance. In addition, the financial firms in this study do not consider disclosure of social performance as a burden, but rather as an opportunity to improve company performance. It is seen from the social performance disclosure that positively affect the financial performance. It is also seen that the variable good corporate governance quality in this case acts as a predictor variable (independent).

## **The Effect of Good Corporate Governance Quality on The Effect of Environment Performance Disclosure on Financial Performance**

Based on table 3, the moderation coefficient of good corporate governance quality on the effect of environment performance disclosure on financial performance is 0.260 with a significance value 0.017 ( $< 0.05$ ) which means  $H_0$  rejected and  $H_6$  accepted. It means that good corporate governance quality weakens the effect of environment performance disclosure on financial performance.

Sustainability report disclosures make the company bear additional costs that will reduce the company's earnings [15]. As a way to improve performance, the company will rely on executive autonomy and corporate governance to monitor and control environment aspects of activities in sustainability reports with effective and efficient decision-making.

But the results of this research do not support the theory. The results of research actually shows that sustainability report produced by companies with good corporate governance quality will degrade financial performance. This is because the basic target held by shareholders when investing capital is to maximize profits. Shareholders certainly have limitations in managing the company, the management (managers) must apply the principle of transparency in reporting all the activities of the company. So that will reduce the agency conflict between shareholders and managers of the company, because of monitoring that oversees the manager of the company to limit personal interests [4].

## **5. Conclusion and recommendation**

Based on the results of the analysis to financial companies that follow CGPI and publish Sustainability Report, the conclusion are: (1) economic performance disclosure negatively affect the financial performance; (2) social performance disclosure has a positive effect on financial performance; (3) environment performance disclosure has a positive effect on financial performance; (4) good corporate governance quality weakens the effect of economic performance disclosure on financial performance; (5) good corporate governance quality has no

moderate effect of social performance disclosure on financial performance; (6) good corporate governance quality weakens the effect of environment performance disclosure on financial performance.

Based on the results of the discussion and the conclusions, some suggestions may be given: (1) Disclosure of sustainability reports is important to do because by disclosing non-financial information such as economic, social and environment performance can provide more benefits not only to the company, but also more benefit for stakeholders. For the Government, it is recommended that there be regulations and standards governing the sustainability report, given the reporting of sustainability report which is still voluntary. (2) In addition to preparing annual reports, it is important for the company to create a Sustainability Report (SR) because the sustainability report is a report that responds to the public or stakeholders' desire to concern corporation about environment. And now the sustainability report has been used as one of the strategies to increase the image of the company which will also improve the financial performance of the company in the future.

## **6. Limitations**

One of the limitations in this study is the lack of research samples, given that few companies follow the Corporate Governance Perception Index (CGPI). It is recommended for further research using different corporate governance measurement methods such as Corporate Governance Disclosure Index (IPCG).

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