Available online at www.sciencedirect.com
ScienceDirect
Procedia - Social and Behavioral Sciences 211 (2015) 411 – 420
Procedia
Social and Behavioral Sciences

2nd Global Conference on Business and Social Science-2015, GCBSS-2015, 17-18 September 2015, Bali, Indonesia

Strategic Corporate Social Responsibility (CSR), Company Financial Performance, and Earning Response Coefficient: Empirical Evidence On Indonesian Listed Companies

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Abstract

The purposes of this study are to examine the effect of strategic CSR and non-strategic CSR on financial performance, and to examine the effect of strategic CSR and non-strategic CSR on earnings response coefficient (ERC). The results of this study show that strategic CSR and non-strategic CSR positively and negatively affect financial performance respectively. The level of strategic CSR disclosed in annual reports positively affect earnings response coefficient (ERC), while the non-strategic CSR does not have an effect on the ERC.
The main contribution of this study is the developing of a checklist matrix to distinguish between strategic CSR and non-strategic CSR.

Peer-review under responsibility of the Organizing Committee of the 2nd GCBSS-2015

Keywords: corporate social responsibility; strategic CSR; non-strategic CSR; financial performance; earnings response coefficient (ERC).

1. Introduction

The purpose of this study is to examine and analyze the effect of strategic CSR and non-strategic CSR on financial performance. Furthermore, in related to signaling, previous study show empirical evidence that shareholders appreciated the disclosure of CSR information in the companies' annual reports (Sayekti & Wondabio, 2007). In contrast to that study this study distinguishes CSR into strategic CSR and non-strategic CSR. This study develops a

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Peer-review under responsibility of the Organizing Committee of the 2nd GCBSS-2015
doi:10.1016/j.sbspro.2015.11.054

matrix checklist to measure strategic CSR and non- strategic CSR. The sample of this study consists of 136 companies listed at the Indonesia Stock Exchange for the period of 2005 – 2008 with total observations of 544 firms-years.

The results of this study show that strategic CSR and non-strategic CSR level positively and negatively affect financial performance respectively. The level of strategic CSR disclosed in annual reports also positively affect earnings response coefficient (ERC), while the non-strategic CSR does not have any effect on ERC. The main contribution of this study is the developing of a checklist matrix to distinguish between strategic CSR and non-strategic CSR. Furthermore, this study provides empirical evidence that strategic CSR and non-strategic CSR have different impact on companies' financial performance and also ERC.

2. Theoretical Background

This study employs stakeholder theory and signaling theory for theoretical background in developing hypotheses. Based on stakeholder theory, the existence of a company is not for the sake of its owners, but also to serve the interests of its other stakeholders, such as employees, government, and society (Utama, 2007). Signaling theory describes that managers would convey signal about the company to its stakeholders (Godfrey et al., 2010). Signaling hypothesis proposed by Watts and Zimmerman (1986) states that signaling motivates corporate disclosure. Company could provide a signal to its stakeholder through a disclosure of information in its financial reports and/or annual reports (Scott, 2009). Managers would expect that its stakeholders, especially the investors, would appreciate the signals sent by the company so then the company's stock price will increase and will benefit the shareholders and the managers themselves (Godfrey et al, 2010).

3. Corporate Social Responsibility (CSR)

One of the CSR definition used widely in the literature is the one stated by Carroll (1979) saying that CSR is "the social responsibility of business encompasses the economic, legal, ethical, and discretionary expectations that society has of organizations at a given point in time." (p. 500). Furthermore, inline with Carroll's (1979), World Bank describes "socially responsible companies consider the full scope of their impact on communities and the environment when making decisions, balancing the needs of stakeholders with their need to make a profit." (Doane, 2005).

Both CSR definitions concern on how to balance the interests of various company's stakeholders. Those definitions are similar to the concept of sustainability from GRI (Global Reporting Initiatives, 2006). GRI concept of CSR adopts triple bottom line approach consists of profit, people, and planet (3P). This triple bottom line concept that was introduced in 1994 by Elkington who argues that to be sustainable a company should developing "win-win-win" strategies to simultaneously benefit the company, its customers, and the environment" (p. 90).

3.1. Strategic CSR

Strategic CSR is an intersection for them who propose CSR and who do not propose CSR because CSR activities incorporated as part of company's strategy that will increase company's financial performance, and at the same time fulfill company's social responsibility to its stakeholders. Porter et al. (2006) analyze strategic CSR based on two forms of interdependence between company and its stakeholders, i.e.: inside-out linkages, and outside-in linkages (pp. 5-6) that normally used to analyze every companies activities so each of it will improve competitive advantage. Inside-out linkages analyze the impact of company's activities on its stakeholders, while outside-in linkages analyze the impact of environment and stakeholders on company (Porter et al., 2006). Porter et al., (2006) employ value chain analysis to evaluate the inside-out linkages, and employ diamond framework analysis to evaluate the outside-in linkages.

In value chain analysis, Porter classifies company's activities into primary activities and supporting activities. Furthermore, Porter (1985) classifies primary activities into 5 categories, i.e.: (1) inbound logistic; (2) operation; (3) outbound logistic; (4) marketing and sales; (5) after sales service. Supporting activities are classified into four categories, i.e.: (1) procurement; (2) technology development; (3) human resource management; (4) firm infrastructure (Porter et al., 2006). CSR activities will then be associated to value chain, both primary activities and/or supporting activities so that those CSR activities would benefit company. While in diamond framework analysis, Porter classifies competitive context into four categories: (1) factor (input) conditions; (2) context for firm strategy and rivalry; (3) local demand conditions; (4) related and supporting industries (Porter et al, 2002, 2006). Company's CSR activities should be linked to those categories so that all CSR activities are expected to affect competitive context of the company. In this study, strategic CSR is a CSR activity that conform the inside-out linkages, and outside-in linkages approach. On the other hand, non-strategic CSR is a CSR activity that does not conform the inside-out linkages, and outside-in linkages.

4. Hypotheses development

4.1. The Effect of Strategic CSR and Non-strategic CSR on Financial Performance

The idea of CSR as a strategy is a way to bridge the gap between the interests of shareholders and the interests of other stakeholders (Porter *et al*., 2002). Based on Porter's et al (2006) inside-out linkages and outside-in linkages approach, then each of CSR activity is expected to improve competitive advantage that will ultimately improve the financial performance of the company. Consistent with Baron (2001) and Lantos (2001), this study also predicts that strategic CSR will affect financial performance positively. Furthermore, this study predicts that non-strategic CSR will affect financial performance negatively.

Therefore, the hypotheses proposed in this study are as follow:
H1: Strategic CSR affect company's Return on Assets (ROA) positively.
H2: Non-strategic CSR affect company's Return on Assets (ROA) negatively
H3: Strategic CSR affect company's Price-to-Book Value (PBV) ratio positively.
H4: Non-strategic CSR affect company's Price-to-Book Value (PBV) ratio negatively

4.2. The Effect of Strategic CSR on Earning Response Coefficient (ERC)

Based on signaling theory, a company would convey company's information to its stakeholders as a signal (Godfrey et al, 2010). This information could take the form of disclosure in the company's annual reports. Disclosures of information on strategic CSR in company's annual reports is one of the ways for company to provide signal to its shareholders that company has a good management in maintaining its stakeholders well while at the same time improve its financial performance (Akpinar *et al*., 2008; Bowman *et al*., 1976; Trotman, 1979). Good management hypothesis argues that there is high correlation between good management practice and CSR activities because company's involvement in CSR activities improves the company's relation to its various stakeholders groups (Ullmann, 1985; Waddock *et al*., 1997). By doing strategic CSR, a company is considered capable in balancing and aligning company's interest and stakeholders' interests. The appreciation of investors to disclosures of strategic CSR information could be measured by the effect of such disclosures on the informativeness of earnings that is measured by Earning Response Coefficient (ERC).

Therefore, the hypothesis proposed in this study is as follow:
H5: Strategic CSR disclosures affect earning response coefficient positively

5. Empirical Models and Variables Definitions

5.1. Empirical Models

The empirical models to test the proposed hypotheses are as follow:

Model 1: To test hypotheses H1 and H2

$$ROA_{i,t} = \beta_0 + \beta_1 StraCSR_{i,t} + \beta_2 NonStraCSR_{i,t} + \beta_3 LogTA_{i,t} + \varepsilon_{i,t} \quad (1)$$

Model 2: To test hypotheses H3 and H4

$$PBV_{i,t} = \delta_0 + \delta_1 StraCSR_{i,t} + \delta_2 NonStraCSR_{i,t} + \delta_3 LogTA_{i,t} + \delta_4 BETA_{i,t} + \varepsilon_{i,t} \quad (2)$$

Model 3: To test hypothesis H5

$$CAR_{i,t} = \alpha_0 + \alpha_1 UE_{i,t} + \alpha_2 StraCSR_{i,t} + \alpha_3 NonStraCSR_{i,t} + \alpha_4 BETA_{i,t} + \alpha_5 PBV_{i,t} + \alpha_6 (UE_{i,t}{*}StraCSR_{i,t}) + \alpha_7 (UE_{i,t}{*}NonStraCSR_{i,t}) + \alpha_8 (UE_{i,t}{*}BETA_{i,t}) + \alpha_9 (UE_{i,t}{*}PBV_{i,t}) + \varepsilon_{i,t} \quad (3)$$

Where:

$ROA_{i,t}$	Return on Assets: ratio of net income plus interest to total assets of company i for period t
$PBV_{i,t}$	Price-to-Book Value Ratio: ratio of company's market stock price to book value of the stock of company i for period t
$CAR_{i,t}$	Cumulative Abnormal Return of company i for period t. The CAR is the accumulation of abnormal return for the period of 12 months starting April 1 to $March_{t+1}$31
$StraCSR_{i,t-k}$	Level of Strategic CSR: measure level of strategic CSR of company i for period t
$NonStraCSR_{i,t}$	Level of Non-strategic CSR: measure level of Non-strategic CSR of company i for period t
LogTAi,t	Log total assets of company i for period t; This variable is control variable to proxy the size of the company.
BETAi,t	Beta (calculated based on market model) is a proxy for systematic risks of company i for period t. The calculation of beta uses period of 12 months starting April 1 to $March_{t+1}$31
$UE_{i,t}$	$UE_{i,t}$ (*Unexpected Earnings* is calculated using random walk assumption, i.e. earnings before extraordinary items in period t is deducted by earnings before extraordinary items in period t-1)
εi,t	error term

5.2. The Measurement of Strategic CSR and Non-strategic CSR

This study employs content analysis to identify Strategic CSR and Non-strategic disclosures in the annual reports. Content analysis is a technique of data collection that coding qualitative information into quantitative scale using a checklist (Abbott et al., 1979). This study develops a checklist instrument to measure strategic CSR and non-strategic CSR level in a matrix form based on CSR categories of GRI Sustainability Reporting Guidelines 2006, and based on analysis inside-out linkages and outside-in linkages of Porter et al (2002; 2006). CSR activities that meet the criteria of strategic CSR (inside-out linkages and/or outside-in linkages) will be classified as strategic CSR, while those CSR activities that do not meet the criteria of strategic CSR then will be classified as non-strategic CSR.

6. Research Sample and Data Collection

The sample of this study consists of 136 out of 397 companies listed in the Indonesia Stock Exchange for the period of 2005 – 2008 with total observations of 544 firms-years. This sample consists of all types of industries listed in the Indonesian Stock Exchange. Data is obtained from several sources, i.e.: the Indonesian Stock Exchange (IDX) website (www.idx.co.id), Indonesian Capital Market Directory (ICMD), The Capital Market Reference Centre, database Osiris, and companies' website. Most of the companies annual reports are obtained in the IDX website and the companies' website.

7. Results of the Study

7.1. Descriptive Statistic

Table 1 presents the descriptive statistic of each variable employed in the empirical models.

Table 1. Descriptive Statistic

Variable	Minimum	Maximum	Average	Std. Deviation
ROA_t	-20,5338	30,2588	4,7696	7,4183
PBV_t	0,0300	19,6897	1,9126	2,3939
$StraCSR_t$	0,0059	0,1170	0.0307	0,0172
$NonStraCSR_t$	0,0513	0,4872	0,1336	0,0663
CAR_t	-15,0380	36,6996	-0,0664	2,6010
UE_t	-2,5427	2,5866	0,0361	0,4204
LogTA	6,8732	11,5544	9,1715	0,9169
BETA	-1,9040	3,7932	0,7867	0,8825

Table 1 shows that the average level of companies strategic CSR is very low, which is only 0,0307 within the scale of 0 – 1, with minimum value of 0.00592 and maximum value is 0.11703. This low average level of strategic CSR indicates that: (1) the awareness of companies to engage in strategic CSR activities is still very low; and (2) companies do not yet comprehend the concept of strategic CSR. Companies have already engaged in general CSR activities (this shown by the average level of non-strategic CSR that is higher than strategic CSR). Table 1 shows that the average level of non-strategic CSR is 0.13361, with the maximum value of 0.48718 and the minimum value 0.05128. This empirical findings consistent with Porter's et al. (2006) argument that many companies doing CSR activities merely to comply to the regulation and to meet the demand of the society without linked it to companies' strategy as a whole. Although the average level of strategic CSR is still very low, but there was an increasing trend that imply that companies' awareness to perform strategic CSR has improved. Furthermore, the average level of non-strategic CSR has also increased. This increasing trend was presumably caused by the issuance of regulation by the Capital Market and Financial Institutions Supervisory Agency in late 2006 regarding disclosure of CSR information in companies annual reports, as well as the implementation of the Company Act in 2007 Article 74 which requires companies in the field of natural resources to engage in social and environmental responsibility, and Article 66 which requires all companies to disclose CSR information in their annual reports.

The empirical data shows that companies which have maximum value of strategic CSR are those classified as high profile industry, such as agriculture, forestry, and fishing; mining and mining service, lumber and wood products, telecommunication, and banking. On the other hand, companies that have minimum value of strategic CSR are those classified as low profile industry, such as hotel and travel agencies, wholesale and retail trade, securities, credit agencies other than bank, apparel and other textile products. These results indicate that companies in high profile industry category tend to have higher strategic CSR than companies in low profile industry category. The data shows similar results for non-strategic CSR where companies in the high profile industry category have higher level of non-strategic CSR than those in the low profile industry category.

7.2. The Empirical Results: The Effect of Strategic CSR And Non-strategic CSR On Companies' Financial Performance

Table 2 presents the regression results of Model 1 and Model 2 that test the hypotheses H1, H2, H3, and H4, i.e. the effect of strategic CSR and nonstrategic CSR on companies' financial performance.

Table 2. Regression Results: The effect of strategic CSR and non-strategic CSR on companies' financial performance

	Pred. sign	Model 1		Model 2	
Dependent Variable:		ROA		PBV	
		Coeff. (t-value)		Coeff. (t-value)	
Constant		35,1242	**	-0,2849	
		(2,4500)		(-0,1807)	
$StratCSR_{i,t}$	+	44,6699	**	9,7495	
		(1,7000)		(0,7636)	
$NonStratCSR_{i,t}$	-	-2,4783		-2,4750	*
		(-0,2100)		(-1,3325)	
$LogTA_{i,t}$	+/-	-3,8607	**	-0,0911	
		(-2,2300)		(-0,3579)	
$BETA_{i,t}$	+			0,1374	**
				(1,6769)	
R^2		0,06528		0,03072	
Adj. R^2		0,05651		0,01959	
F		3,3000	***	2,76228	**
p-value		0,0077		0,01186	

*** Sign at $\alpha = 1\%$

** Sign at $\alpha = 5\%$

* Sign at $\alpha = 10\%$

The empirical results shown in Table 2 indicate that, consistent with the prediction, the level of strategic CSR affects significantly positive companies performance (measured by accounting financial performance, ROA). This results imply that CSR activities aligned with companies operations and strategy will give positive impact on companies' themselves. This empirical evidence supports the concept of strategic CSR of Baron (2001), Bhattacharyya (2010), Lantos (2001), and Porter (2006) which argue that company could determine and engage CSR activities that align social objectives and company's objectives that in turn would increase company's financial performance. The finding is also consistent with strategic stakeholder management model developed by Berman et al. (1999) who consider that stakeholders should be well managed so then it would provide benefit to company's performance. Referring to the aspects of stakeholder theory proposed by Donaldson et al. (1995), the empirical results are inline with the second aspect, namely the instrumental aspect stating that companies performing stakeholder management would, ceteris paribus, have a better performance. Social impact hypothesis (Preston et al, 1997) also conforms to the view that if companies take care of their stakeholders' needs, then it will in turn improve companies' performance. Another view that also consistent with the empirical findings is the good management theory (Waddock et al, 1997), and the view of causal-related marketing and strategic philanthropy (Godfrey et al, 2006).

Regarding non-strategic CSR, Table 2 shows the empirical findings that consistent with the prediction that there is a significant negative impact of non-strategic CSR on financial performance (measured by market financial measurement, PBV). These results indicate that even though the market does not consider strategic CSR to influence companies' performance, but the market give 'punishment' to the companies who engaged in non-strategic CSR activities. The market views those CSR activities that do not align with companies' business will give negative impact to companies' performance. This negative impact of non-strategic CSR on financial performance is explained by Baron (2001) that argues if companies' motivation to do CSR activities is altruism (philanthropy), then its effect on financial performance will be negative. Trade-off hypothesis states that the cost of CSR activities will cause company to be less competitive compared to other companies that do not engage CSR activities especially if those CSR activities are not aligned with the companies strategy (Aupperle et al, 1985; Ullmann, 1985).

On the other hand, the empirical evidence also shows that the level of strategic CSR does not affect significantly on market financial performance even though the sign of the coefficient is positive. Also the effect of non-strategic CSR on accounting financial performance even though the sign of the coefficient is negative, but it does not show significant result. McWilliam et al (2001) describe the neutral effect of strategic CSR activities on companies' financial performance. They argue that companies doing CSR activities will gain higher revenue than companies that do not do CSR activities. Although the company has a higher income, but the company also spend higher cost related to its CSR activities. Thus, the profit of companies that do not do CSR would be no different than those that do CSR (McWilliams et al, 2001). The empirical results also show the neutral effect of strategic CSR and non-strategic CSR on financial performance.

In conclusion, the empirical evidence support the hypothesis H1 stating that strategic CSR affect company's ROA positively, and also the hypothesis H4 stating that non-strategic CSR affect negatively company's PBV ratio. On the other hand, the empirical evidence of this study does not support the hypothesis H2 stating that non-strategic CSR affect negatively company's ROA, and does not support hypothesis H3 stating that strategic CSR affect positively company's PBV ratio.

Generally, the empirical findings of this study indicate that companies and market participants have been able to distinguish between companies' strategic CSR and non-strategic CSR. Therefore, it is important for the company to emphasize on strategic CSR activities and reduce the non-strategic CSR activities so then the company would gain positive impact of its strategic CSR activates, and minimize the negative impact of its non-strategic CSR.

7.3. The Empirical Results: The Effect of Strategic CSR On Earnings Response Coefficient (ERC)

Table 3 presents the regression results of Model 3, which tests the hypothesis H5, i.e. Strategic CSR disclosures affect earning response coefficient positively.

Table 3. Regression Results: The Effect of Strategic CSR On Earnings Response Coefficient (ERC)

Dependent Variable:: CAR

	Pred. Sign	Coeff. (t-value)	
Constant		0,1003	
		(0,2341)	
$UE_{i,t}$	+	-0,2991	
		(-0,5896)	
$StratCSR_{i,t}$	+	-7,0532	*
		(-1,2974)	
$NonStratCSR_{i,t}$	-	-1,6765	
		(-0,9625)	
$BETA_{i,t}$	+	0,3193	**
		(1,7979)	
$PBV_{I,t}$	+	-0,0042	
		(-0,0482)	
$UE_{i,t}*StraCSR_{i,t}$	+	41,4115	**
		(2,1457)	
$UE_{i,t}*NonStraCSR_{i,t}$	-	0,5667	
		(0,1576)	
$UE_{i,t}*BETA_{i,t}$	-	-0,6463	**

		(-2,2177)	
$UE_{i,t}*PBV_{i,t}$	+	0,2468	*
		(1,5516)	
R^2		0,0391	
Adj. R^2		0,0220	
F		2,2888	**
p-value		0,0159	

*** Sign at α = 1%

** Sign at α = 5%

* Sign at α = 10%

The empirical evidence shown in Table 3 indicates that disclosure of strategic CSR information affect the ERC significantly positive, while disclosure of non-strategic CSR information does not affect the ERC. Thus, this empirical evidence supports the hypothesis H5. With the disclosure of strategic CSR information, investors are expected to have additional information in making investment decision, and not merely based their decision on earning information. The disclosure of strategic CSR information is viewed by the market participants as good news and as a signal of good management. By doing strategic CSR activities company shows that it is capable to manage its stakeholders well, and yet company can have benefit from those CSR activities. This shows company's ability in internalizing CSR activities into company's operation that will positively affect its financial performance. A signal of good management is an indication of good earning quality that will increase company's ERC (Scott, 2009).

The empirical model 3 also includes non-strategic CSR variable as control variable, which is predicted to affect the value of ERC. Table 3 shows that non-strategic CSR does not affect the value of ERC. These results of the study indicate that the market is able to distinguish CSR strategic and non-strategic CSR. Therefore, it is important for companies to determine and to engage in CSR activities that align with companies' business and strategy.

8. Conclusions, Implication, Limitation, and Suggestion for Further Studies

8.1. Conclusion and Implication

The objective of this study is to examine and analysis the effect of strategic CSR level on financial performance, and also its effect on earning response coefficient (ERC). This study develops a matrix checklist to measure the strategic CSR and non-strategic CSR level based on value chain and diamond framework concepts of Porter et al. (2006) combined with the GRI (Global Reporting Initiatives) checklist. The sample of this study consists of 136 companies listed in the Indonesia Stock Exchange for the period of 2005 – 2008 with total observations of 544 firms-years.

The empirical evidence indicate that the level of strategic CSR positively affect companies' financial performance, while the level of non-strategic CSR negatively affect companies' financial performance. This results consistent with the strategic stakeholder management concept of Berman et al (1999), and strategic CSR concept of Baron (2001), Battacharyya (2010), and Lantos (2001) which argue that CSR activities are supposed to provide benefits not only for company's stakeholders, but also give benefits to company itself. The empirical evidence also indicates that companies and shareholders are able to distinguish between strategic CSR and non-strategic CSR. This study explains the inconclusive results of previous studies since the previous studies did not distinguish CSR activities into strategic CSR and non-strategic CSR.

Furthermore, this study provide empirical evidence that disclosures of strategic CSR information affect positively companies' ERC, while disclosures of non-strategic CSR information does not affect companies' ERC. The market (investors) considers strategic CSR information as good news and as a signal of good management. It suggests that company is capable in balancing and aligning company's interest and stakeholders' interest. This good management indicates that there is a good quality of earnings, which in turn will increase the value of ERC (Scott, 2009).

The implication of this study is that it is important to distinguish CSR activities into strategic CSR and non-strategic CSR in examining and analyzing their impact on company's financial performance since they have different impact. This distinction may contribute an understanding the inconclusive results of previous studies. Also, it is important to make that distinction in examining and analyzing the impact of CSR activities on earning response coefficient (ERC).

8.2. Limitations and Suggestions for Further Research

This study has some limitations as follow:

1. This study employs content analysis method on companies' annual reports to measure the level of strategic CSR and non-strategic CSR. Even though this method has advantages, but this method also has a drawback, i.e. the document used as media of content analysis sometimes is more serving as public relation and not necessarily reflects actual activities.
2. The matrix checklist employed in this study does not differentiate for various industry categories. Each industry category may emphasize differently on one or more GRI items, such as banking industry and mining industry.
3. This study measures strategic CSR and non-strategic CSR based on dichotomy approach. This study does not apply a scale on each item in the checklist. This dichotomy approach does not reflect the intensity of CSR activities.

Based on the research limitations mentioned above, following are some suggestions for further research:

1. Further research could use other information sources as an addition to companies' annual reports to measure strategic CSR and non-strategic CSR, such as sustainability reports or standalone CSR reports to get better pictures of companies' CSR activities.
2. Further research might consider distinguishing checklist for each industry category in order to get a more precise measurement of strategic CSR and non-strategic CSR based on each industry characteristics.
3. Further research might consider applying scale in each item in the CSR checklist to reflect the intensity of CSR activities.

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