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# THE ROLE OF PROFITABILITY IN THE RELATIONSHIP BETWEEN ENVIRONMENTAL DISCLOSURE AND FIRM VALUE

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## ABSTRACT

This study aimed to examine the consistency of the effects of environmental disclosure on firm value and investigate profitability as a moderating variable. The samples in this study were companies that won the Sustainability Reporting Award (SRA) and the Asia Sustainability Reporting Rating (ASRAT) presented by the National Center for Sustainability Reporting (NCSR) in the 2014-2020 period. A total of 82 companies were sampled. This study used secondary data taken from company databases and the Indonesia Stock Exchange (IDX)/*Bursa Efek Indonesia* (BEI). The multiple regression equation model was analyzed using IBM SPSS 20 software. The results showed that environmental disclosure negatively and significantly affected firm value. Furthermore, research documented that environmental disclosure had a positive and significant effect on firm value when profits were high. These findings have provided evidence that the differences in results on the relationship between environmental disclosure and firm value are due to a conditional factor, namely profitability. Based on the stakeholder theory, fulfilling stakeholder interests has a positive effect if the company has good financial performance. Meanwhile, based on the signaling theory, financial information is required for non-financial information to be effective.

**Keywords:** environmental disclosure; firm value; profitability; Tobin's Q

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## INTRODUCTION

For several decades, the disclosure of company social responsibility (CSR) has been a focus of research, both overall and per component. Because environmental disclosure can be part of a company's strategy to increase firm value, it has become one of the most highlighted research objects, particularly if it is related to sustainable development, which is currently in its second cycle and is referred to as the sustainable development goals (SDGs). This cycle strongly encourages social and environmental awareness to become one of the company's strategies. Business entities are expected to be more creative in identifying win-win solutions, i.e., a situation in which commercial goals and social and environmental goals can be realized (Agarwal et al., 2017).

In Indonesia, studies on the relationship between environmental disclosure and company performance have been conducted, but the results have not been conclusive. Deswanto, & Siregar, 2018) obtained empirical evidence that environmental disclosure does not affect the market value of a company. Meanwhile, studies conducted by ((Setiadi et al., 2017), (Sawitri, 2017), Latifah & Luhur (2017), and Setiadi & Agustina (2019) found that environmental disclosure was significantly positively related to firm value. According to Baron & Kenny (1986), the difference in results is possible due to situational variables that affect the relationship, such as the characteristics of the company.

To prove this, several efforts have been made to include profitability as a situational variable that moderates the relationship between environmental disclosure and firm value, as found in the research by Latifah & Luhur (2017), Budiana et al. (2020), and (Setiadi & Agustina (2019). However, the results of this moderation model study also give distinctive results. Latifah & Luhur (2017) and Budiana et al. (2020) obtain empirical evidence that profitability moderates the relationship between environmental disclosure with firm value, while Setiadi & Agustina (2019) have proven that profitability does not moderate the relationship.

The causes for the different findings of these studies are difficult to pinpoint. A literature review of the research object reveals that the object is random or not patterned. This also happens to the size used for the dependent variables. Positive and significant relationships between environmental disclosure and firm value were also identified in the studies with the objects of companies as the following: (1) manufacturers (Setiadi & Agustina, 2019), (2) Indonesia Sustainability Reporting Award (ISRA) participants (Budiana & Budiasih, 2020), (3) LQ45 shares (Sawitri, 2017), and (4) mining companies or chemical industry (Setiadi et al., 2017). The literature review also discovered that the gap in results was caused by differences in the measurement of firm value. The study by Deswanto & Siregar (2018) which did not find any relationship, used stock prices for firm value, whereas studies that found a relationship used Tobin's Q.

This present study aimed to evaluate the consistency of previous studies' results related to the object and measurement of firm value by re-examining the relationship between environmental disclosure and firm value and by using moderating variables as introduced by Budiana & Budiasih (2020). The findings of this study are expected to contribute to measurement and research objects by confirming previous studies.

### Hypothesis Development

Hypotheses in this study are based on the signaling theory and stakeholder theory. Spence (1973) proposed the signaling theory for the first time using the labor market to model the signaling function of education. At the time, potential employers lacked information about the quality of prospective workers, and education can serve as a signal about the quality of prospective workers, reducing information asymmetry (Connelly et al., 2011). This theory was then widely applied in research on information disclosure, both financial and non-financial. The information disclosed by the company is thought to reduce the information asymmetry between the agent and the principal. Recent

research has focused on the disclosure of non-financial information, for example, sustainability report information that can provide a signal to its users (Dewi & Sudana, 2015).

Stakeholder theory arose from the seminal work of Freeman (1984), which raised awareness of the need for aspects of firm social responsibility in firm planning activities. CSR was initially thought to contribute significantly to the overall performance of the company and was the goal of stakeholders including the community (Dooms, 2019). These stakeholders have a wide range of interests that may conflict with one another. Companies must be capable of balancing the various stakeholders' interests, as this is the company's purpose in the context of stakeholder theory (Ansoff, 1965). Stakeholder theory emphasizes the importance of all parties (stakeholders) who are directly or indirectly affected by the company's activities (Wearing, 2005). Companies must consider every impact of their actions on stakeholders or parties who own stock in the company (Wicks et al., 2004).

**Effect of environmental disclosure on firm value**

Al-tuwaijri et al. (2004) explained that environmental disclosure is a collection of information about a company's environmental management activities in the past, present, and future. Based on the stakeholder theory, the purpose of a company is to improve the welfare of all stakeholders, instead of merely the welfare of shareholders (Lukviarman, 2005). Companies that manage stakeholder relationships will have an impact on their ability to continue running their businesses, which means ensuring their survival. Companies also aim to strike a balance between their various interests (Ansoff, 1965). Companies must understand and manage what matters to stakeholders (Freeman et al., 2004). According to Dhaliwal et al. (2014), stakeholder-oriented companies are stronger and have more influence to carry out activities, are very responsive to information requests, and provide quality information.

Environmental disclosure is a representation of the company's responsibility to stakeholders (Setiadi & Agustina, 2019) to meet the diverse interests of stakeholders. Environmental disclosure provides stakeholders who are not investors or creditors with non-financial information of interest. If stakeholders believe that companies have accommodated their interests, they will provide positive feedback (Ullmann, 1985). This feedback can take the form of product loyalty, maintenance of investment, or invitation of potential investors to invest in the companies, allowing them to increase the value of shares, which in turn increases the firm value (Callan & Thomas, 2010; (Waddock & Graves, 1997). Environmental policies also promote transparency, reduce uncertainty, and boost competitive advantage (Daromes, 2020).

Environmental disclosure, in addition to serving stakeholder interests, is intended to reduce information asymmetry in the context of signal theory (Cormier et al., 2009). Because good information quality reduces uncertainty in decision making, investors will have a positive perception or view of the companies due to reduced information asymmetry. The company's future opportunities will be more certain with less information asymmetry (Rosiana et al., 2013).

Environmental disclosure as part of firm social responsibility will attract and improve the company's perceptions among investors. According to Martin & Moser (2016), companies that voluntarily disclose their environmental practices receive a positive response from their investors. This positive perception and response will have a positive economic impact on the company and will reflect the firm value (Iatridis, 2013). Therefore, hypothesis 1 is formulated as follows.

H1: Environmental disclosure has a positive effect on firm value.

**The effect of profitability on the relationship between environmental disclosure and firm value**

Profitability refers to a company's ability to generate profit, which is one of its goals. Several studies have used profitability as a proxy for financial performance, which is typically assessed by accounting performance measures like ROA or ROE (for example, Fauzi et al. (2007) and Andayani (2015)). Several studies treat profitability as a company characteristic, and in its development, the company's characteristic in the study is used as a control variable, as in the studies of Zi-hang et al., (2014); Faisal et al., (2012); Osma & Guillamón-saorín, (2011); Mallin & Michelon, (2011).

Profitability, as a characteristic of a company, can be positioned as a moderating variable, that is, a variable that influences the relationship between the independent variable and the dependent variable. This study builds on previous research by Budiana & Budiasih (2020), Latifah & Luhur (2017) and Setiadi & Agustina (2019), which have positioned profitability as a moderating variable, where profitability was treated as a situational variable. These studies employed the same model but diverse objects and measurements.

Companies with high profitability will be able to conduct more environmental activities, and thus environmental disclosure will be high (Qiu et al., 2014). In such a case, the company, based on the signaling theory, provides more information, reducing information asymmetry. Reducing information asymmetry is expected to improve stakeholders' perceptions, which in turn increases the company's value. High profitability offers guarantees to stakeholders, particularly investors and creditors, regarding the rates of returns (dividends) and loan repayment rates, so they are not concerned about meeting the needs of other stakeholders. In the stakeholder theory, this is referred to as balancing stakeholder interest. When profitability is low, the main stakeholders expect it to be prioritized, so that high environmental disclosure will reduce the firm value because there are concerns that the rate of return and loans cannot be met. This signifies that high profitability strengthens or has a positive effect on the relationship between environmental disclosure and firm value, while low profitability has a negative effect. There is empirical evidence supporting the logic of a positive relationship, as found in the research of Setiadi & Agustina (2019). However, the research by Latifah & Luhur (2017) and Budiana & Budiasih (2020) reported no evidence that profitability is a moderating variable. Based on the logic of the theory and supporting studies, the second hypothesis is formulated as follows.

H2: Environmental disclosure has a significant, positive effect on firm value when the company's profitability is high; on the contrary, environmental disclosure has a significant, negative effect on firm value when the company's profitability is low.

Figure 1 presents an empirical research model that describes the conceptual framework of the research representing the two hypotheses that have been formulated. The research uses a moderation model with profitability as a moderator and environmental disclosure as a predictor of firm value.

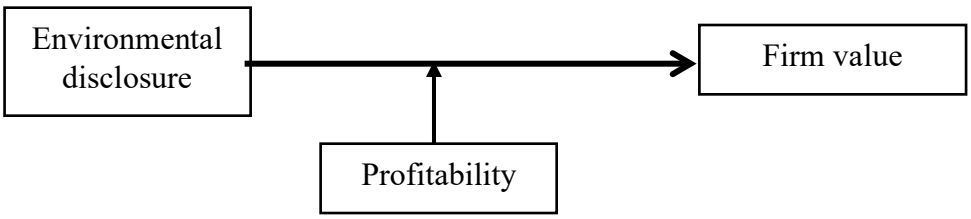


Figure 1. Empirical Research Model

## RESEARCH METHOD

### Population and Samples

The research population consists of companies that received the SRA and the ASRAT presented by the NCSR. Purposive sampling was used to obtain the research samples based on the following criteria: (1) award-winning companies from 2014 to 2020; (2) companies that have issued sustainable reports using GRI (Global Reposting Initiative) standards and GRI G4 standards. The final samples were 82 companies, obtained from 95 companies reduced by 13 companies (outliers/data with extreme distribution, which would bias the results if included). The detailed samples are presented in Table 1. The observation period of 2014 - 2020 was chosen because before 2014, the disclosure measurement standard used as an assessment standard did not apply GRI or GRI G4 Standards, and the last data obtained is data for 2020 when this research was conducted.

The focus of this research is on environmental award-winning companies because of the empirical data that research on environmental disclosure in Indonesia, with the objects of award-winning companies and particular industries, yields diverse results. Companies with good environmental performance (especially proxies with PROPER) tend to be more transparent and have good financial performance (See Ratmono et al., 2014 and Daromes & Kawilarang, 2020), while in some industries, they are not significantly related (e.g. Fauzi et al., 2007). Therefore, this study was carried out to test the consistency of previous studies' findings that companies with good environmental reputations received positive responses from stakeholders, particularly investors.

Table 1. Research sample collection process

| Criteria | Number of Companies |
|---|---|
| Companies winning the award from NCSR in the 2014-2020 period | 197 |
| Companies not listed in the IDX or companies that are not public companies | (101) |
| Companies that did not publish sustainability reports based on the GRI or GRI G4 Standards | (1) |
| Total samples before reduced by outliers | 95 |
| Outliers in the samples | (13) |
| Total samples in the study | 82 |

### Research Variables

This study used four types of variables: dependent variable, independent variable, moderating variable, and control variable. The dependent variable in this study was firm value, which was proxied with Tobin's Q, as used by Youn et al. (2015), Youn et al. (2016), and Ho et al. (2016). Tobin's Q was calculated by dividing total market value (MV) and DV by total assets (AT). The sustainability report disclosure index (SRDI) was used to measure environmental disclosure as the independent variable. The index was estimated by dividing the number of items disclosed by the company by the maximum number of items. Profitability serves as a moderating variable in this study. In several studies, profitability is classified as a component of the company's characteristics, which enable it to act as a moderator. Profitability is thought to influence the relationship between the dependent and independent variables, in terms of strengthening or weakening the relationship between the two variables (Latifah & Luhur, 2017). It is determined using return on assets (ROA). ROA is calculated by dividing net income by total assets. The last two variables are control variables, namely leverage and firm size. Leverage refers to a company's ability to pay off its debts, whether long-term or short-term.

The greater the leverage is, the greater the proportion of funding provided by debt will be. Leverage is yielded by total debt divided by total assets (Belkaoui & Karpik, 1989). The size of the company can be determined by the total assets, sales, or company equity. Total assets were used as a proxy for firm size in this study. The total assets owned by the company can demonstrate that the company is established in its business operations (Suwardika & Mustanda, 2017).

**Data and Analysis Method**

This study used secondary and quantitative data obtained from the company's official website to obtain sustainability report data. The financial data were attained from the official website of the Indonesia Stock Exchange (IDX). Multiple regression was used to analyze the data, with the following equation.

$$Y=\alpha + \beta_1 X_1 + \beta_2 Z_1 + \beta_3 X_2 + \beta_4 X_3 + \beta_5 X_1 * Z_1 + e$$

| | |
|---|---|
| Y | = Firm value |
| α | = Constant |
| $\beta_1 ... \beta_2 ... \beta_3 ... \beta_4 ... \beta_5$ | = Regression coefficient |
| $X_1$ | = Environmental disclosure |
| $Z_1$ | = Profitability |
| $X_2$ | = Company size |
| $X_3$ | = Leverage |
| e | = error term |

Table 2. Descriptive statistics

| | N | Minimum | Maximum | Mean | Standard Deviation |
|---|---|---|---|---|---|
| Firm value | 82 | 0.676 | 17.935 | 1.520 | 1.859 |
| Environmental disclosure (ED) | 82 | 0.000 | 1.000 | 0.260 | 0.217 |
| Firm size (FS) | 82 | 28.966 | 34.887 | 31.729 | 1.300 |
| Leverage | 82 | 0.005 | 1.136 | 0.580 | 0.256 |
| ROA | 82 | -0.567 | -0.401 | -0.052 | 0.067 |
| ED X ROA | 82 | -0.040 | 0.204 | 0.015 | 0.034 |

## RESULTS AND DISCUSSION

**Descriptive Statistics**

Table 2 presents descriptive statistics, including standard deviation, as well as mean, minimum, and maximum values. The mean firm value was 1.520, which was lower than the minimum value of 0.676 and the maximum value of 17.935. This mean value was smaller than the standard deviation of 1.859, indicating the high data variation and uneven distribution. Since the disclosure ranged from 0 (minimum) to 1 (maximum), the mean environmental disclosure of 0.260 was also low (maximum). The standard deviation of environmental disclosure was 0.217, which was less than the mean value, suggesting low data variation and even data distribution. The mean of the firm size was 31.729, which fell between the minimum value of 28.966 and the maximum value of 34.887. The mean value of firm size was high, exceeding the standard deviation value of 1.300. This indicates that the data variation was low, implying that the data distribution was even. The average leverage is 0.580 with a standard deviation of 0.256, as well as low data variation and evenly distributed data. The mean value of leverage was quite high, ranging between a minimum value of 0.005 and a maximum value of

1.136. The standard deviation was 0.067 and the mean value of negative ROA was 0.052. Based on the mean value and the standard deviation, the data variation was high and the data distribution was uneven, while the mean value was lower than the standard deviation. The average ROA was extremely low, ranging from a of -0.567 (minimum) to (maximum) of -0.401.

**Results of Classic Assumption Test**

To produce an unbiased estimate (Best Linear Unbiased Estimation abbreviated BLUE) from data analysis with multiple regression, classical assumption testing was required Table 3 summarizes that the four classical assumption tests met the criteria. Each test yielded the following results: (1) normality was indicated by a K-S value of 1.260 with a significance level of 0.083 (> 0.05); (2) heteroscedasticity was performed with Spearman and Rho tests with all variables having a significance level of above 0.05; (3) multicollinearity was indicated by a tolerance value of more than 0.01 and a VIF value of less than 10 for all variables; and (4) autocorrelation was performed by Durbin-Watson (DW) test, resulting in the value of 1.756, which was between dU and 4-dL (1.540< 1.756 < 4- 1.744).

**Results of Hypothesis Test**

**Results of test on the relationship between environmental disclosure and firm value**

Table 4 summarizes the results of hypothesis testing. The table shows that environmental disclosure (ED) has a negative coefficient of 0.257 with a significance level of less than 1% (0.001). Although significant, the direction of the relationship contrasted the hypothesis, so H1 was rejected. The negative relationship indicates that the greater the environmental disclosure is, the lower the firm value will be. Based on the statistical data, environmental disclosure and firm value had low mean values, but the firm value had an uneven distribution, which may be one of the reasons why the relationship was statistically negative.

Table 3. Results of classical assumption test

| Model | Normality | Multicollinearity | | Autocorrelation | Heteroscedasticity |
|---|---|---|---|---|---|
| | | Statistical collinearity | | Durbin-Watson | Sig. |
| | | Tolerance | VIF | | |
| Environmental disclosure (ED) | Nilai K-S 1.260 (0.083) | 0.520 | 1.923 | 1.756 | 0.345 |
| Firm size (FS) | | 0.738 | 1.352 | | 0.125 |
| Leverage | | 0.799 | 1.252 | | 0.365 |
| ED x ROA | | 0.481 | 2.077 | | 0.142 |

The significant negative relationship between environmental disclosure and firm value suggests that stakeholders, particularly investors, have reacted negatively to environmental disclosure. Based on the findings of this research, there are at least three factors underlying the fact that empirical results did not support the hypotheses. *First*, from the signaling theory standpoint, the low environmental disclosure is not sufficient to reduce information asymmetry, making investors unable to rely on the information as a basis for making a decision, resulting in negative perceptions. *Second*, from stakeholder theory, the stakeholders' possible different interests are challenging to satisfy if the condition of the company is not good, as indicated by the level of company profitability. Based on the company's statistical data, ROA as a proxy for profitability had a relatively small mean value, as indicated by the results of the second hypothesis testing. *Third*, there is a possibility that the pandemic affected the firm value, causing ineffectiveness of company disclosure. The company

disclosure, which should send a signal of a transparent company, reduce uncertainty, and increase competitive advantage (Iatridis, 2013) became ineffective due to the uncertainty surrounding the company. The low firm value might not be due to negative environmental information, but rather to the uncertain economic conditions during the pandemic, which shifted investors' priorities in dealing with the pandemic situation.

The findings of the study on the relationship between environmental disclosure and firm value contradict the outcomes of the previous research by Budiana & Budiasih (2020) that used a similar model and object. They discovered a significant positive relationship between the two variables. The differences are thought to be due to the different measurements of independent variables. This study only focuses on environmental disclosure as a predictor of firm value, whereas Budiana & Budiasih (2020) may use all components of the sustainability report (SR). They did not specify the measurement method, only mentioning SR as the independent variable.

This study is consistent with Deswanto & Siregar (2018) that reported the absence of a relationship between environmental disclosure and market value as measured by stock prices for mining, chemical, and agricultural companies. In their research, stock prices were primarily determined by financial variables, such as book value per share, earnings per share, and ROA.

**Results of test on the effects of profitability on the relationship between environmental disclosure and firm value**

Table 4 depicts that the coefficient value of the interaction variable between profitability and environmental disclosure (ED*ROA) was positive at 0.226 with a significance level of less than 1% (0.000). This suggests that H2 statistically was accepted, that is, environmental disclosure will have a positive effect on firm value if the company's profitability (ROA) is high. The results of the H2 test have confirmed the H1 test, because the ROA was low (between -0.567 and -0.401) so high environmental disclosure will reduce firm the value or vice versa.

These results support the stakeholder theory that stakeholder interests are diverse and can be conflicting. To fulfill their interests, companies must have sufficient capabilities obtained from high profitability. This is also in line with the CSR concept of Carroll (1999), that economic responsibility is a fundamental requirement of the existence of a business to be socially responsible. If the company cannot fulfill its economic responsibilities in generating profits, the company can stop running its business, and therefore cannot fulfill other responsibilities. The results of this study provide an understanding that environmental disclosure may reduce information asymmetry if the company's economic condition is good. Thus, if non-financial information is positive, financial information also becomes a positive signal. Thone H2 test results support the research by Setiadi & Agustina (2019), which focused on manufacturing companies. The test results, however, did not support the findings of Budiana & Budiasih (2020), that of the ISRA-winning companies, and Latifah & Luhur (2017), who used the entire companies as the objects. The results from the H1 and H2 tests have not been consistent.

Table 4 presents that firm size and leverage had no significant effect on firm value. Firm size had a negative coefficient of 1.490 with a significance level greater than 10% (0.231), whereas leverage had a negative coefficient of 0.058 with a significance level greater than 10% (0.365). For SRA and ASRAT winning companies, firm size and leverage did not determine the firm value. These findings contrast with those of Ho et al. (2016) that empirically proved the significant negative relationship between firm size and leverage and firm value in American firms using the Kinder, Lynderberg, and Domini (KLD) data. The results also differ from the research by Setiadi & Agustina (2019) which documented a significant positive relationship between firm size and firm value in manufacturing companies in Indonesia.

Table 4. Results of the hypothesis test

| Model | Unstandardized Coefficient | | Standardized Coefficient | t | Sig. |
|---|---|---|---|---|---|
| | B | Std. Error | Beta | | |
| (constant) | 6.112 | 4227 | | 1.446 | .152 |
| ED | -.257 | .072 | -.433 | -3.558 | .001 |
| FS | -1.490 | 1.234 | -.123 | -1.207 | .231 |
| Leverage | -.058 | .064 | -.089 | -.911 | .365 |
| ED*ROA | .226 | .039 | .735 | 5.820 | .000 |

## CONCLUSION

The purpose of this study is to investigate the consistency of the relationship between environmental disclosure and firm value, with profitability serving as a moderator. This study has proven that there is a significant inverse relationship between environmental disclosure and firm value. The significant negative result in the relationship between environmental disclosure and firm value suggests that the pandemic contributes to the situation. Nevertheless, the findings support the notion that the differences in results from previous studies are due, among other things, to the features of the company, which are measured by profitability as evaluated with ROA.

The results of this study have several implications. *First*, this study strengthens the stakeholder theory that the fulfillment of the interests of various stakeholders requires a good economic condition of the company, which in this study is represented by profitability. Furthermore, support for signaling theory implies that the effectiveness of non-financial information in reducing information asymmetry is also determined by profitability. *Second*, in practice, these findings indicate that investors, as the company's primary stakeholders, must prioritize their interests for the company to have the flexibility to meet the interests of other stakeholders. *Third*, these outcomes reinforce previous findings that companies with a strong commitment to environmental management have greater performance potential.

Despite its careful planning, this study has some limitations. *First*, on one side, this study used the samples of SRA and ASRAT winning companies as well as data from companies listed on the IDX. On the other hand, because many SRA and ASRAT winners were not listed on the IDX, the sample size was smaller and might not be representative of companies not listed on the IDX. The two may have different characteristics. Therefore, there is still an opportunity to conduct research to observe companies winning SRA, ASRAT, or other environmental-related awards, which are associated with other financial performance, as a proxy for company value, because stock prices as a component of firm value do not exist in companies that have not been listed on the IDX. *Second*, this study utilized a sample period of 2014-2020, in which in the last two years, environmental conditions have run abnormally due to the pandemic, potentially influencing the results. Thus, research that focuses on pandemic conditions or separates samples and compares them is required. *Third*, the findings of this study indicate that the relationship between environmental disclosure and firm value is influenced by company profitability, implying that other variables, such as firm governance, may influence the relationship between the two variables.

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