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Impact of Integrated Reporting Implementation on Cost of Capital

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Abstract: *This study aims to examine one of the factors that reduce the cost of capital of a company, which has the potential to provide an explanation for the tendency to increase the disclosure of companies that adopt integrated reporting (IR). The samples taken and selected in this study are based on purposive sampling for companies that meet the measurement criteria on each research variable with SOE companies listed on the Indonesia Stock Exchange that have published IR in 2020-2022. The results in this study indicate that disclosure in IR has a negative and significant effect on the cost of debt and has no effect on the cost of equity. These results indicate that corporate disclosure in the form of IR, which is an annual report that integrates financial and non-financial performance, only affects the company's cost of debt.*

Keywords: integrated reporting, cost of capital, cost of debt, cost of equity

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1. Introduction

There are concerns that traditional corporate reporting is insufficient to meet the information needs of a wide range of stakeholders (Adams & Simnett, 2011). Many companies have attempted to increase the information available for decision making by stakeholders by supplementing their traditional financial reporting with reporting of non-financial information (Cohen et al., 2012). This non-financial information is usually reported in various reporting mechanisms, such as sustainable reporting, corporate social responsibility (CSR) reports, or in annual reports (Sìmnett et al., 2011). Additional information in the form of non-financial information is proven to have relevant value and can be used by stakeholders as a consideration in terms of decision making (Dhaliwal et al., 2009). However, financial and non-financial reports are disclosed in separate report formats, so they are not provided to facilitate the understanding of the company's stakeholders. Thus, the usefulness of the information provided is reduced.

The need to fulfil information for decision-making has made the scope of financial reporting grow. Currently, the trend of corporate reporting formats is starting to develop into integrated reporting (IR). This phenomenon emerged as a result of the global financial crisis that hit America in 2008. (Azam et al., 2011). One of the factors that caused the crisis was the criticism of the annual report, which was considered not to cover all aspects that are useful for assessing the company's overall performance (Krzus, 2011). This makes it difficult for users of financial statements to determine business decisions.

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In this regard, although IR is considered as a solution to overcome the problem of misleading information in annual reports and overcome the criticism of sustainability reporting, not many companies have reported financial and non-financial information in the form of IR. For example, in the S&P 500 index, only seven companies report in IR, although 499 provide some sustainability disclosures (Investor Responsibility Research Center Institute (IRRCI), 2013).

Researchers focus on testing the relationship between the disclosures of companies that adopt IR and the cost of capital, both on the cost of debt and equity. It is important to examine the relationship between disclosure and cost of capital which is an important part of the financial accounting literature (Botosan, 1997; Francis, Khurana, & Pereira, 2005; Hail, 2002). The basic idea of the relationship is that a higher level of disclosure will contribute to a decrease in the information asymmetry between managers and investors, and consequently may lead to a decrease in the idiosyncratic component of the cost of capital (Diamond & Verrecchia, 1991). Research related to disclosure and cost of capital has mixed results, one of the reasons being the low variation of information disclosure by firms. In addition, Hail (2002) argues that the absence of statistically and economically significant associations between disclosure and cost of capital can be a measurement problem, as both variables are not directly observed and the use of proxies is required. Lopes and de Alencar (2010) found that there is a weak relationship between disclosure and cost of capital.

In this regard, researchers are motivated by issues related to IR and capital markets, especially on the effect of disclosure of companies that adopt IR on the cost of capital. IR is a mechanism proposed by the International Integrated Reporting Council (IIRC) that encourages companies to be able to produce reports that integrate the company's financial and non-financial information. IR has the benefit of increasing transparency in the company's operations, with increased transparency, it will increase stakeholder confidence (Azam et al., 2011; Cheng, Ioannou, & Serafeim, 2014; Serafeim, 2015). Disclosure through IR is expected to improve the quality of corporate reporting, because better reporting quality can have an impact on reducing the cost of capital.

Previous research has examined the determinants of companies to disclose information through IR, but there has been no research that empirically examines the disclosure of companies that adopt IR and the cost of capital. Cheng et al. (2014a) suggest that financial information is insufficient to inform the capital market regarding the organization's "true" value creation potential. Therefore, it is important to empirically test whether IR can influence the capital market. The disclosure of companies that adopt IR is still basically voluntary, as not all countries have mandated IR, except in South Africa which has required all companies in 2010 to publish IR. Therefore, this study focuses on the disclosures of companies that adopt voluntary IR and the cost of capital of companies, both the cost of debt and equity.

The researcher examined one of the factors, namely a decrease in the cost of capital of a company, which could potentially provide an explanation for the tendency of increased disclosure of companies that adopt IR. Among the various potential factors that can influence disclosure decisions, researchers focus on the cost of capital because it can play an important role in the financing and general operating decisions of a company. In addition, the main objective of IR is to provide a clear link between information in financial statements and non-financial statements that allows for improved assessment of the company's performance on an ongoing basis. Thus, this study focuses on disclosure through IR as a solution to overcome problems in other corporate reporting such as sustainability reporting that is no longer effective in communicating corporate performance information to investors. Furthermore, this study can

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extend the findings of previous studies related to disclosure and cost of capital. The problem raised in this study is whether disclosure through IR affects the cost of capital.

2. State of the Art

2.1 Agency Theory and Disclosure

Information asymmetry occurs when there are certain parties in a transaction that have more information than other parties. Thus, there is a possibility that those with more information can take advantage of those with less information (Embong et al., 2012). Problems related to information asymmetry are inseparable from conflicts that occur between managers and owners or better known as agency theory (Jensen & Meckling, 1976).

Agency theory explains the relationship between company owners and their agents, namely management who play a role in running company operations. Healy and Palepu (2001) shows that to overcome agency problems can be overcome by making compensation agreements agreed between management and company owners. One of the contents of the compensation is to disclose relevant information by managers, so that company owners are able to evaluate whether their funding is managed properly or not by management.

In this regard, to overcome agency problems, companies must also have good corporate governance (CG), where CG is the way company management is responsible to company owners or shareholders (Claessens, 2003). The principle of CG that is closely related to disclosure is the principle of transparency. This principle relates to openness in conveying information submitted by the company. In this case, investors rely heavily on information submitted by the company. Therefore, companies are required to provide information that is clear, accurate, timely and comparable to the same indicators, as well as disclose and convey this information to all interested parties. Disclosure in this study uses company disclosures that use IR which integrates information related to the company's financial and non-financial performance.

Disclosure through IR is expected to have better information quality than other reporting such as sustainability reporting. Better information quality can be seen from the company's level of transparency through disclosure which is a way that can be used to monitor management performance and can reduce information asymmetry. Diamond and Verrecchia (1991) found that disclosure can reduce information asymmetry which results in a decrease in the special components of the cost of capital, such as reducing the cost of equity, operating costs, and reducing risk estimates. The reduced information asymmetry due to disclosure has an impact on reducing the agency risk faced by investors, which in turn will influence investors to reduce the expected return on the company.

2.2 Disclosure through IR and Cost of capital

Several theoretical and empirical studies have examined the impact of disclosure and the cost of capital. From a theoretical point of view it has been argued that disclosure can reduce information asymmetry, and consequently can reduce the cost of equity capital of the firm (Diamond & Verrecchia, 1991). However, an empirical result is highly dependent on the disclosure measures and the cost of equity capital (Francis et al., 2005; Francis et al., 2005).

Francis et al. (2005) tested the same relationship in an international context using a sample of 34 countries. They also find that firms in industries with greater external financing needs have higher levels of voluntary disclosure, and when disclosure policies are extended to these firms,

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it leads to a decrease in the cost of capital both the cost of debt and equity. Sengupta (1998) found that high disclosure quality firms will have lower interest costs when issuing debt. This suggests that companies that have clear disclosure policies can reduce the cost of debt. Hail (2002) found that there is a significant negative relationship between voluntary disclosure and cost of capital.

In this study, researchers relate disclosure and cost of capital in the context of voluntary IR disclosure. Since there is no empirical evidence that examines disclosure through IR with the cost of capital, this study is based on the results of previous studies that have found that disclosure is negatively related to the cost of capital (Botosan, 1997; Dhaliwal et al., 2011; Francis et al., 2005; Hail, 2002; Lopes & de Alencar, 2010; Richardson & Welker, 2001). Disclosure through IR is expected to improve the quality of corporate reporting, because better reporting quality can have an impact on reducing the cost of capital, both the cost of debt and equity. Based on the arguments and results of previous research, the hypothesis of this study is:

H1a : Corporate disclosure through IR negatively affects the cost of capital as measured by the cost of debt.
H1b : Corporate disclosure through IR negatively affects the cost of capital as measured by the cost of equity.

3. Methods

3.1 Research Population and Sample

This study uses secondary data consisting of data on companies that publish IR and data for components of the cost of capital obtained from the Bloomberg database. The data used in this study is the IR of companies listed on the Indonesia Stock Exchange, as well as data to calculate the cost of capital consisting of earnings per share (EPS) forecasts, stock prices (P), and interest costs. The population in this study are all companies listed on the Indonesia Stock Exchange that have disclosed their annual reports using Integrated Reporting. The sample determination was carried out by purposive sampling, with the aim of obtaining samples in accordance with predetermined criteria.

3.2 Variable Measurement

The dependent variable in this study is the cost of capital proxied by the cost of debt and the cost of equity. a. Cost of debt capital (COD) is the interest rate that the company must pay on its loans. Cost of debt is calculated from the amount of interest expense paid by the company in one year divided by the amount of long-term debt and short-term debt that generates loan interest during the year (Francis et al., 2005). The following formula for calculating COD refers to Francis et al. (2005) and Sengupta (1998).

$$COD_t = \frac{rd_t\ (1 - T_t)}{SD_t - LD_t}$$

Description: CODt is the cost of debt capital for year t; rdt is the interest cost for year t; T1 is the tax rate paid for year t; SDt is short-term debt for year t; and LDt is long-term debt for year t. b.

Cost of equity capital (COE) which uses a measurement based on the price earning growth (PEG) ratio. This measurement of COE reflects an estimate of the implied cost of equity.

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Researchers used the methodology of Easton (2004) to estimate the ex ante cost of equity capital because it has data requirements that can be met by all samples in this study, and only requires price and earnings growth data to calculate the cost of equity capital. In this approach, the firm-specific ex ante cost of equity capital is defined as the square root of the inverse PEG ratio. The following formula for calculating the cost of equity capital refers to Francis et al. (2005) and Lopes and de Alencar (2010).

$$r_{PEG} = \sqrt{\frac{eps_2 - eps_1}{P_0}}$$

Description: r_{PEG} is the ex ante cost of equity capital, where PEG refers to the price earning growth model; eps1 is the earnings per share forecasted for year t+1; eps2 is the earnings per share forecasted for year t+2; and P0 is the stock price in year t.

This study uses disclosure through IR which is measured using the GRI G4 index (Global Reporting Initiative G4 content index). GRI G4 was developed in accordance with the international IR framework published by IIRC in 2013. Based on the eight information contents in the IR framework, content analysis is used to measure the content of information disclosed in IR, with code 1 if there is disclosure and 0 if there is no disclosure. The calculation for the GRI G4 index is:

$$DIR = \frac{\sum N}{149}$$

Description: N is the total information disclosed. DIR is the disclosure score in IR

3.3 Data Analysis Technique

This study examines the relationship between disclosure through IR and the cost of capital. The relationship between disclosure and cost of capital is inherently methodologically problematic, as neither disclosure nor cost of capital can be directly observed (Lopes & de Alencar, 2010). In this regard, the researcher follows the model proposed by Botosan (1997) and also used by Hail (2002), Francis et al. (2005) and Lopes and de Alencar (2010) which is the main econometric specification in this study, namely:

$$COC_{it} = f\,(disclosure,\ control\ variable)$$

Furthermore, the function equation was implemented using a panel data model and the hypotheses in this study were tested using multiple regression analysis. Before the regression analysis was conducted, the researcher tested the classical assumptions which is a requirement that the regression model used has met the BLUE (Best Linear Unbiased Estimator) requirements. This research model consists of 2 models that have been adjusted to the research hypothesis. In the first hypothesis which aims to examine the effect of disclosure through IR and the cost of capital, the research model formed consists of two models, namely the model for testing disclosure in IR on the cost of debt hereinafter referred to as model 1a and the model for testing disclosure in IR on the cost of equity hereinafter referred to as model 1b. The equation model is:

$$CoD_{it} = \alpha + \beta_1 \boldsymbol{DIR}_{it} + \beta_2 LASSET_{it} + \beta_3 ROA_{it} + \beta_4 LEV_{it} + \varepsilon_{it} \qquad \textbf{Model 1a}$$

$$CoE_{i\,t} = \alpha + \beta_1 \boldsymbol{DIR}_{it} + \beta_2 LASSET_{it} + \beta_3 ROA_{it} + \beta_4 LEV_{it} + \varepsilon_{it} \qquad \textbf{Model 1b}$$

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4. Results and Discussion

4.1 Research Data

The population in this study were all state-owned companies in Indonesia. The sample of companies was selected with the criteria of state-owned companies listed on the Indonesia Stock Exchange. The data used in this study were obtained from the website of each SOE company used as a sample in this study. In addition, SOE company data in the form of annual reports published during 2020 - 2022. In connection with the data of SOE companies that have published their annual reports in the form of integrated reports, there are limitations to the research sample that publishes integrated reports. Based on the observation of the research sample, there are 20 SOE companies listed on the Indonesia Stock Exchange. This study focuses on the application of integrated report components using the GRI G4 index (Global Reporting Initiative G4 content index) developed in accordance with the international IR framework published by IIRC in 2013.

4.2 Hypothesis Testing Results and Discussion

Hypothesis one (H1) states that corporate disclosure through IR negatively affects the cost of capital. H1 is supported if the DIR coefficient is significant and negative. The following are the results of multiple regression analysis for each model in testing H1.

Table 1: Regression Analysis Results: Effect of Disclosure in IR on Cost of Capital

Variable	Predicted Sign	Parameter Estimates (t-statistics in parenthesis) Dependent Variable			
		CoD		CoE	
		Model 1a		Model 1b	
Intercept	?	0.091	(2.229)**	0.039	(2.246)**
DIR	-	-0.099	(-2.373)**	-0.025	(-1.537)
LASSET	-	0.005	(1.108)	-0.002	(-1.269)
ROA	-	-0.010	(-0.073)	0.061	(1.099)
LEV	+	0.059	(1.167)	0.049	(1.747)*
MBR	+			-0.001	(-0.253)
DER	+			0.003	(0.506)
Adj R^2		0.076		0.094	
N		60		60	

*, **, *** significant at 0.10, 0.05, and 0.01 respectively

Variable Definition: CoDit = cost of debt for firm i in year t, which is measured by interest expense for year t divided by long-term debt and short-term debt (Sengupta 1998).Sengupta 1998)CoEit = cost of equity for firm i in year t, as measured by the ex ante cost of equity capital using the price-earning growth (PEG) ratio (Easton 2004)DIRit = disclosure through IR based on the disclosure index in GRI G4 for company i in year t, as measured by a score of 1 if disclosed and 0 if not disclosed; ROAit = return of assets of company i in year t; LASSETit = natural log of total assets of company i in year t; LEVit = ratio of short-term and long-term debt to total assets of company i in year t; MBRit = market-to-book ratio of company i in year t; DERit = debt-to-equity ratio of company i in year t.

4.2.1 Phase I: Model 1a

The regression equation to test model 1a (cost of debt as the dependent variable) is as follows:

$$CoD_{it} = \alpha + \beta_1 \boldsymbol{DIR}_{it} + \beta_2 LASSET_{it} + \beta_3 ROA_{it} + \beta_4 LEV_{it} + \varepsilon_{it} \quad \ldots\ldots \textbf{Model 1a}$$

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The regression analysis results in table 1 model 1a show that disclosure in IR (DIRit) has a significant negative effect on the cost of debt (t-stat -2.373; sig 0.05). This finding is also in line with the research results of Francis et al. (2005) who found that when the disclosure policy is expanded, it can cause a decrease in the cost of debt, especially for companies that have large external financing needs. Sengupta (1998) also found that companies that have high disclosure quality will have lower interest costs when issuing debt, so that the disclosure policy can reduce the cost of debt. Thus, it can be said that the findings of this study support the proposed H1.

Disclosure in this study is disclosure in the form of IR which is a new reporting format issued by the IIRC in 2011. This result indicates that the broader the scope of disclosure and the better quality of disclosure can be used to monitor management performance and companies tend to have a low cost of capital. These results also support the findings of Garcia and Nogurea (2017) who revealed that the disclosure of financial information provides important economic benefits for companies, with a negative relationship between the cost of capital and integrated report disclosure indicating a decrease in the cost of capital as a result of integrated report disclosure especially relevant for companies that need to increase their funding base. Such companies have considerable problems with asymmetric information or they operate in markets with limited protection for investors.

In the regression analysis results, there is no effect of the control variables, namely company size (LASSETit), profitability (ROAit), and leverage (LEVit) on the cost of debt. This result contradicts the findings of Bhojraj and Sengupta (2003) who suggest that financial ratios can help stakeholders in determining their investment decisions. Thus, this result indicates that the external financing required by the company does not depend on the size of the company, as well as financial ratios such as ROA and leverage, because stakeholders can utilize other information disclosed by the company in considering their investment decisions, such as integrated financial and non-financial disclosure information.

4.2.2 Phase II: Model 1b

The regression equation to test model 1b (cost of equity as the dependent variable) is as follows:

$$CoE_{i\,t} = \alpha + \beta_1 \boldsymbol{DIR}_{it} + \beta_2 LASSET_{it} + \beta_3 ROA_{it} + \beta_4 LEV_{it} + \beta_6 DER_{it} + \beta_7 MBR_{it} + \varepsilon_{it}$$

Model 1b

The regression analysis results in Table 1 model 1b show that disclosure in IR (DIRit) has no effect on the cost of equity (t-stat -0.197; sig > 0.05). This finding does not support the proposed H1. This finding is also in line with research by Francis et al. (2008) who found that voluntary corporate disclosure has no impact on reducing the cost of equity. Furthermore, Francis et al. (2008) stated that the insignificant result on the relationship between disclosure and cost of equity can be caused by the use of measurement of cost of equity which is directly difficult to trace if it is related to disclosure. In addition, Easton, (2004) also stated that although the PEG ratio has high construct validity for measuring the cost of equity, the PEG ratio is said to be a valid construct when earning forecasts by analysts are categorized as accurate. So that further analysis is needed related to the use of cost of equity measurements that have various measurements. These findings also support the findings of Botosan (1997) who found no effect of disclosure and cost of equity for companies that have a large analyst following.

In relation to the results of the analysis and findings of previous research, the quality of disclosure in the form of IR, which is said to be better than other forms of disclosure such as sustainability reports and CSR, does not necessarily have a direct impact on reducing the cost

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of equity in the short term. This is because the complexity of disclosure in IR, which integrates financial and non-financial performance into one reporting format, causes companies to readjust what information must be disclosed in order to be displayed in one reporting format that can describe the company's financial and non-financial performance. Lopes and de Alencar (2010) stated that the weak relationship between disclosure and cost of equity is due to the mandatory disclosure which results in lower variation in the level of disclosure.

Hsiao (2021) found that voluntary adoption of IR is more likely by companies with established sustainability practices. The findings suggest that IR is an incremental innovation for sustainability, rather than an innovation that radically changes management and reporting practices. As such, the study found no evidence of a relationship between voluntary IR adoption and the information environment, cost of equity, or firm value. However, additional analysis provides preliminary evidence that suggests capital market impacts may be different for firms adopting IR with higher sustainability or market performance.

In the regression analysis results, there is no effect of company size (LASSETit), profitability (ROAit), market to book ratio (MBRit), and debt to equity ratio (DERit) on the cost of equity, but for the leverage variable (LEVit) has a significant effect on Cost of Equity.

5. Conclusion

This study aims to provide empirical evidence related to the relationship between disclosure in IR and the cost of capital both cost of debt and cost of equity. Several previous studies have provided mixed evidence related to the relationship between disclosure and cost of capital (Botosan & Plumlee, 2005; Dhaliwal et al., 2014; Diamond & Plumlee, 2014). The disclosures in this study focus on the disclosures of companies that adopt IR and the cost of capital during the period 2020-2022. Based on the results of the analysis, this study found that disclosure in IR only affects the company's cost of debt, and no evidence was found regarding the effect of disclosure in IR on the cost of equity. Therefore, H1 in this study is partially supported.

Disclosure in IR does not fully reduce the cost of capital, this can be caused by the large number of variations in the items disclosed in IR. In addition, it is related to the measurement of the cost of equity which has many measurement variations, causing the findings related to the relationship between disclosure and cost of equity to have mixed results. This again supports the statement Botosan (1997) which states that the relationship between disclosure and cost of equity has mixed results and no definite conclusion can be found. Related to these results, although IR aims to integrate financial and non-financial performance in one reporting format, in the short term the application of IR has little impact on capital markets, in this case the cost of capital. Thus, disclosure through IR is not necessarily a more effective and better reporting mechanism in communicating company performance with stakeholders. Companies need to make considerations to disclose information related to their company's performance in the form of IR or not, as long as IR is still voluntary.

Future research, can examine related to disclosure and cost of capital by comparing companies that disclose IR and sustainability reporting with cut off before and after the company adopts IR. With the aim, it can be known that corporate reporting has better information quality for stakeholders. In addition, future research can examine the disclosure of companies that adopt IR mandatorily such as South African companies listed on the Johannesburg Stock Exchange in relation to the cost of capital.

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