# CHAPTER I

# INTRODUCTION

## 1.1 Background

Reporting is one way to publish information to stakeholders. A company's performance report is an essential tool for assessing the financial health and overall performance of a business. It is mainly expect to overview the company's financial health, including revenue, expenses, profits, and losses. This information helps stakeholders understand the company's financial position and make informed decisions. That is become the reason why a company's financial report is an important tool for communicate with stakeholders, including investors, lenders, and employees. By providing a clear and transparent view of the company's financial health, it can help build trust and confidence in the company.

Along with the development of business, technology, and global issues, the information needs of stakeholders are getting higher. As the business environment has become more complex and interconnected. Thus, their success depends on various factors beyond financial performance, such as sustainability, corporate social responsibility, and ethical practices. In this case, financial information alone may not provide a complete picture of a company's risk profile.

Additional concern of investors is that, they are increasingly focus on long-term value creation rather than short-term financial gains. They are interested in a company's growth potential, innovation strategies, competitive advantage, and the ability to adapt to changing market dynamics. By obtaining a deeper understanding of a company's business model, they expect to be able to assess company's prospects for sustainable growth and evaluate whether it aligns with their investment goals (Vitolla et al., 2019).

On response of these trends, on December 9, 2013, the International Integrated Reporting Council (IIRC) published the International Integrated Reporting Framework (IIRF). The Integrated Reporting, by its character is a concise communication about how the strategy, governance, performance and prospects of an organization, in the context of its external environment, lead to the short, medium and long term companies value creation. As defined in Vitolla et al. (2019).

*"Integrated reporting (IR) is an innovative reporting tool that includes financial and nonfinancial information developed by the International Integrated Reporting Council (IIRC). This evolution of corporate reporting aims to overcome the limits of traditional reporting and, therefore, to better represent companies' value creation process"*

This report basically integrating financial information with relevant non-financial information, such as environmental impact, social initiatives, corporate governance, and strategic outlook. Thus, companies can satisfy escalated stakeholders information needs by enhancing transparency and provide stakeholders with a comprehensive understanding of their business model, value creation strategies, and their impact on each party (including stakeholders).

The implementation of Integrated Reporting (IR) is explained by Sari (2017), as it is still on the early phase of adoption, globally on average. However, Berndt et al. (2014) as stated in Sari (2017), that most of the Swiss Market Index companies apply IR at the middle level, and most of other European country needs to improve and adjust to International Integrated Reporting Framework (IIRF). This statement leads us to the question of to what extent IR being implemented in Indonesia.

Currently in Indonesia, there are several types of report commonly prepare by listed company. There are; Annual Reports, Sustainability Reports, and Financial Statement. The Annual Report, especially regarding a summary of important financial data, stock information, company profiles, good corporate governance, and corporate social responsibility. Financial Statements mostly contain information about comparisons of the financial year and the previous year, statements of financial position, statements of comprehensive income, reports of changes in equity, reports of cash flows, and notes on financial statements. Meanwhile, the Sustainability Report in Indonesia contains information on how financial services support the creation of sustainable economic growth by aligning economic, social and environmental interests. This facts is apparently shows us that

Indonesian public companies have published Annual Reports that combine financial and non-financial information as with IIRF generally instructed. Thus, evaluation according to IIRF of annual reports prepared by Indonesia companies is feasible (IAPI, 2022).

The evaluation is important to conduct in order to understand of how much Indonesia companies adopted the content element of Integrated Reporting that is highly beneficial to improve the quality of reporting and develop trends in global market demands. The benefit of applying IIRF has been a concern to IAPI/ Institut Akuntan Publik Indonesia. IAPI act as in conducting implementation studies/ research and drafting IR preparation guidelines. This fact shows us the urgency of integrated reporting research needs in Indonesia upon the development of the framework and it's implementation in Indonesia.

Currently, IFAC as a Global Professional Accountant Organization has encouraged all its members to adopt and implement Integrated Reporting in their respective Jurisdictions. This could bring impacts on the more coherent enterprise reporting system, and fulfills a need for a single report that provides a more complete picture of an organization's ability to create value. In its development it is considered as a response to market demand for corporate business opportunities, where businesses and investors on average in each country have been pioneers in the development of the concept by the IIRC and contributed to the development of the framework. Companies that have used it can benefit from increased professional analysis for investments.

Furthermore, the compliance on IIRF is stated to give benefit to the company itself. According to iapi.or.id, there are communications, risk management, and costs benefits from complying IIRF. The communications benefits are; the information reported is more in line with the needs of investors, more accurate non-financial information, stronger collaboration between different functions in the organization, and more consistent and efficient internal and external reporting. From management perspective, the benefit of complying IIRF are; gain trust from major shareholders, improve the ability to identify and manage risks, and improve risk governance. Meanwhile, the benefits from the cost perspective covers better resource allocation decisions, identify better opportunities for operational efficiency and innovation, and lower cost of capital due to better disclosure.

As it is stated to be cost advantages, the IIRF application supposed to be attractive to be done from company's point of view. In fact, a research conducted by Zhou et al. (2017) found that increase compliance with IIRF is associated with the subsequent reduction of cost of equity capital. This finding explained by Vitolla et al. (2019) as the IIRF compliance influence the cost of capital through a reduction in the estimation risk, information asymmetry, monitoring costs for investors, and altered-ability of investors' preferences.

However, greater disclosure that believed to be beneficial offered by IR application, not always bring reduction in cost of equity. As stated in Vitolla et al. (2019), the research conduct by Richardson and Welker (2001) found a positive relationship, that the greater disclosure of social information increases the cost of equity. This research somehow doesn't specifically address the report as Integrated Reporting, and to what extent the company disclose the non-financial information. This situation justify the need of further research, specifically conducted according to Integrated Reporting application quality, that can better explain the correlation between Integrated reporting application to cost of equity based on the quality of Integrated Reporting.

This research analyzes the impact of Integrated Reporting quality on the cost of equity of Indonesia companies listed in LQ45 index. The main reference in developing this research is conducted by Vitolla et al. (2019), entitled *"The impact on the cost of equity capital in the effects of integrated reporting quality"*. It is conducted on 116 international firms from various sector. Another main reference is quality assessment paper conducted by Agustia et al. (2020). They conduct quality assessment of integrated reporting of 63 European firms years 2016-2017. By referring to these main reference, the novelty of this research are, this research conduct on Indonesia with Indonesia companies listed in LQ45 index being the object.

## 1.2 Research Question

Based on the background above, the question that going to be researched in this paper are:

1. How is the level of quality scoring of company listed in LQ45 index's annual report, according to International Integrated Reporting Committee (IIRC). By conducting annual report evaluation refer to Integrated Reporting Framework (IRF).
2. How does the Integrated Reporting Quality (IRQ) affect Cost of Equity (COE) according to IIRC. By conducting correlation analysis of measured COE and IRQ score.

## 1.3 Research Objective

Based on the formulation of the research question above, the objectives of this research are as follows:

1. To measure the quality of annual report of Indonesia Company listed in LQ45 index according to IIRF guiding principle and content element.
2. To examine the correlation of Integrated Reporting Quality towards company's Cost of Equity.

## 1.4 Research Benefit

The benefit from conducting this research encompasses few parties.

1. Academics

   This research is expected to enrich source of knowledge in the field of Integrated Reporting and its quality assessment, as well as its correlation with company's Cost of Equity.
2. Financial Service Authority (OJK)

   This research useful to regulatory entity, in Indonesia OJK (Otoritas Jasa Keuangan), to be taken into consideration on adopting the Integrated Reporting.
3. Future research

   This research is expected to add insights and source of reference for further research development in particular Integrated Report topic.

### 1.5 Scope and Limitations

The study conducted limited to Indonesia companies listed in LQ45 index, which consist of 45 most liquid companies listed in Indonesia Stock Exchange. The data being used are obtain specifically from the yearly financial statements of companies listed in LQ45 index years 2021 and 2022.

### 1.6 Writing Systematic

This research structure is divided into several sections. That can be define by following explanation, as follows:

Chapter I: introduction

This chapter describes how integrated reporting gradually become a trend of reporting framework consist of financial and non-financial element. Followed by the benefit of applying International Integrated Reporting Framework (IIRF) and supporting research conveying the benefit of cost of equity, i.e. research background. The rest of the chapter are the formulation of problem underlies this research i.e. problem statement, the objectives, and benefits of the research, scope and limitation of study, and writing systematic which includes the brief description about each chapter.

Chapter II: literature review

This section examines the theoretical basis and previous related-research of integrated reporting and cost of equity, as known as literature review and previous study. This section is to be followed by hypothesis development, and ended with chart of conceptual framework.

Chapter III: research methodology

This chapter discuss the research methods of this study, consisting the research variables and operational definition of each variables, population and sample, types and sources of data, data collection methods, and data analysis methods.

Chapter IV: result and analysis

This chapter comprises the analysis, presentation, and interpretation of the findings resulting from this study.

Chapter V: conclusion

In this final section, there will be highlights of the research findings and results followed by the limitation and suggestion of the research in the subsequent sub-section of this chapter.