Intellectual capital, CSR, and earnings quality impact on equity cost of capital

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ABSTRACT

Companies need additional funds to improve their business activities, and one source of these funds is investors, which involves the cost of equity capital. Several factors influence the cost of equity capital, including the disclosure of intellectual capital, corporate social responsibility (CSR), and earnings quality. This study empirically examines the impact of intellectual capital disclosure, CSR, and earnings quality on the cost of equity capital. The research sample consists of 30 manufacturing companies in the consumer goods industry sector listed on the Indonesia Stock Exchange during the 2017-2021 period. The results show that intellectual capital disclosure, CSR, and earnings quality significantly affect the cost of equity capital in manufacturing companies within the consumer goods industry. Higher disclosures of intellectual capital and CSR are expected to enhance a company's transparency and reputation, thereby reducing the cost of equity capital. However, the findings also indicate that increased disclosure can heighten investors' perceived risk, which, in turn, raises the cost of equity capital. The implication is that companies need to balance information disclosure to effectively manage perceived risk and optimize the cost of equity capital.

ABSTRAK

Perusahaan memerlukan dana tambahan untuk meningkatkan kegiatan usahanya. Salah satu sumber dana tambahan adalah dari investor, yang dikenal dengan biaya modal ekuitas. Faktor-faktor yang mempengaruhi biaya modal ekuitas termasuk pengungkapan intellectual capital, corporate social responsibility (CSR), dan kualitas laba. Studi ini bertujuan menguji secara empiris pengaruh pengungkapan intellectual capital, CSR, dan kualitas laba terhadap biaya modal ekuitas. Sampel penelitian mencakup 30 perusahaan manufaktur sektor industri barang konsumsi yang terdaftar di Bursa Efek Indonesia selama periode 2017-2021. Hasil penelitian menunjukkan bahwa pengungkapan intellectual capital, CSR, dan kualitas laba memiliki pengaruh signifikan terhadap biaya modal ekuitas di perusahaan manufaktur sektor industri barang konsumsi. Pengungkapan intellectual capital dan CSR yang lebih tinggi diharapkan dapat meningkatkan trans-paransi dan reputasi perusahaan, sehingga menurunkan biaya modal ekuitas. Namun, hasil penelitian ini mengindikasikan bahwa peningkatan pengungkapan tersebut justru dapat meningkatkan persepsi risiko investor, yang pada akhirnya meningkatkan biaya modal ekuitas. Implikasinya ada-lah perusahaan perlu mempertimbangkan keseimbangan dalam pengungkapan informasi untuk mengelola persepsi risiko dan biaya modal ekuitas secara efektif.

Kata Kunci:
Intellectual capital disclosure, Corporate social responsibility, Earnings quality, Cost of equity capital.

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1. INTRODUCTION

The cost of equity capital is a crucial metric for firms as it directly affects their financial performance and valuation. Understanding the factors that influence the cost of equity capital, such as intellectual capital, Corporate Social Responsibility (CSR), and earnings quality, is essential for firms aiming to optimize their capital structure and enhance their competitiveness in the market (Ahmed et al., 2019). Expanding a company's business requires additional funds sourced from external financing, such as issuing stocks or bonds to be traded on the capital market. Comprehensive information about the company is essential for investors to make informed decisions, particularly the information presented in the company's financial statements (Kurnia & Arafat, 2015). According to Efrina & Faisal (2017), investors are more attracted to liquid companies, making it easier for such companies to obtain funds from investors. This consideration stems from the inherent risk and return of an investment.

When a company secures additional funds from investors, it must bear the economic consequences, which are referred to as the cost of equity capital (Pramita, 2016). A notable phenomenon in the manufacturing companies within the consumer goods industry sector is the fluctuation in the cost of equity capital. This cost is measured using the Capital Asset Pricing Model (CAPM) to calculate the cost of equity capital, assisting investors in deciding whether the company is worth investing in. The cost of equity capital is crucial component of the overall cost that influences investment decisions.

Table 1 shows the fluctuations in the cost of equity capital for five manufacturing companies in the consumer goods industry sectors listed on the Indonesia Stock Exchange during the 2017-2021 period. The decision to analyze the cost of equity capital for only five companies is justified for several scientific reasons, in Table 1. These companies were selected to represent diverse industry characteristics, such as size, market position, and financial health. This approach allows the analysis to identify key trends while maintaining a manageable scope for the study.

Table 1
Cost of Equity Capital Data 2017-2021

Company Name	Code	Cost of Equity Capital				
		2017	2018	2019	2020	2021
PT Akasha Wira Internasional	ADES	0 .044	0.002	-0.020	0.179	-0.039
PT Sariguna Primatirta	CLEO	0.027	0.047	-0.094	0.082	0.059
PT Delta Djakarta	DLTA	0.044	0.024	-0.043	0.134	-0.059
PT Hanjaya Mandala	HMSP	0.171	0.046	-0.018	0.081	0.200
PT Indofood Sukses	INDF	0.053	0.049	0.047	0.104	-0.042

Source: www.idx.co.id (data processed)

The observed increases and decreases in the cost of equity are due to unstable stock prices and market risk, which affect investors' investment values. The annual changes in the cost of equity capital can influence investors' decision-making processes. Therefore, companies must take various measures to minimize the cost of equity capital to maximize their firm value.

Intellectual capital, Corporate Social Responsibility (CSR), and earnings quality are crucial factors that influence a company's equity cost of capital. Intellectual capital encompasses the intangible assets and knowledge within an organization, which can impact the cost of equity capital through its disclosure and management (Larasati & Novita, 2017). On the other hand, CSR involves a company's commitment to ethical practices, social causes, and environmental sustainability, which has been found to affect the cost of equity capital positively (Chen et al., 2019; Al-Khouri & Suwaidan, 2022; El Ghoul et al., 2011; Ofogbe et al., 2021). Furthermore, the quality of earnings, as reflected in financial reporting, can also influence a firm's CSR performance and subsequently its cost of equity capital (Bose & Yu, 2023).

The cost of equity capital plays a crucial role in investors' decision-making processes, prompting researchers to examine additional factors that influence it, such as intellectual capital disclosure (Salvi et al., 2020). The rapid advancement of information technology has led to the emergence of the knowledge-based economy, where economic activities are driven by knowledge and information technology or communication. In assessing and measuring this knowledge-based economy, the intellectual capital approach is used. A significant challenge with intellectual capital is that its value cannot be explicitly observed in financial statements due to issues related to its identification, recognition, and measurement. Therefore, one proposed alternative to reveal a company's intellectual capital value is to enhance intellectual capital disclosure in annual reports. The disclosure of intellectual capital provides insights into the company's performance, which stakeholders can use for investment decision-making (Rivandi, 2018).

CSR represents a company's responsibility for the impact of its decisions and activities on society and the environment. Effective CSR not only benefits sustainable community development but also helps companies enhance their public image, improve their refinancing capabilities, and overall competitiveness (Li & Liu, 2018). Social responsibility can be manifested through transparent and ethical behavior. According to Sukarti & Suwarti (2018), CSR disclosure in financial reports provides additional information to investors. Studies have also explored the relationship between CSR disclosure and the cost of equity capital, with findings indicating that higher quality CSR reporting is linked to lower equity capital costs. Additionally, the incorporation of companies into Socially Responsible Investment (SRI) indices has been found to impact their cost of equity capital and corporate value (Eom & Nam, 2017).

Earnings quality is another critical factor for investors in making investment decisions. It serves as a measure to determine whether the reported earnings in financial statements truly reflect the company's performance. Higher earnings quality provides better information about the company's actual performance and helps in making informed decisions (Pratiwi, 2020). Investors, potential investors, financial analysts, and other users of financial information must thoroughly understand the true quality of earnings. The earnings achieved by a company are a key performance indicator and are considered by investors when making investment decisions. High-quality earnings enable accurate assessment of current performance and can be used as a basis for predicting future performance (Monalisa, 2018).

The research objectives of this study include examining the individual and combined effects of intellectual capital, CSR activities, and earnings quality on the cost of equity capital. Through analyzing these relationships, the study aims to contribute to the existing literature on corporate finance and provide practical implications for firms looking to reduce their equity costs through strategic management of intellectual capital, CSR initiatives, and earnings quality. The novelty of this study lies in its comprehensive analysis of the interplay between intellectual capital, CSR activities, and earnings quality in influencing the cost of equity capital. By considering these factors collectively, this research offers a holistic understanding of how firms can strategically manage their resources and practices to optimize their equity cost of capital and improve their financial performance.

2. THEORETICAL FRAMEWORK AND HYPOTHESIS

Brigham & Houston (2019), signaling theory suggests that when a company makes decisions about how to finance its operations, such as by borrowing money or selling shares of stock, it sends signals to the market about its future prospects. Investors interpret their decisions as either positive or negative signals about the company's management confidence and its future outlook. For instance, taking on new debt can be viewed as a positive signal indicating management's belief in the company's ability to generate profits, while issuing new stock can be seen as a negative signal reflecting uncertainty or the possibility of a decline in stock value. This theory helps explain how financing decisions affects the cost of capital and how investors perceive the level of risk associated with a company.

Intellectual Capital Disclosure of Cost of Equity Capital

Academic research has thoroughly investigated the correlation between intellectual capital disclosure and the cost ofeEquity capital. Nugroho et al. (2021) identified a negative association between the qualities of corporate social responsibility (CSR). As they reported, that the equity capital costs indicates that higher-quality CSR disclosure tends to lower these costs. Likewise, El Ghoul et al. (2011) emphasized that corporate governance at the firm level, analyst coverage, and financial constraints are linked to CSR activities and equity capital costs, suggesting a potential relationship between CSR initiatives and the cost of equity capital.

Mondal & Ghosh (2020) highlight that disclosing intellectual capital is a crucial method for reporting the inherent nature of intangible assets. According to Salvi et al. (2020), intellectual capital internally contributes to creating and enhancing company profits. Externally, it generates a competitive advantage, enabling the company to establish and maintain strong relationships with external stakeholders such as customers, shareholders, and lenders. Research by Putri & Rokhmania, (2018); Anggraeni & Indarti (2021); Santoso & Deviyanti (2022) demonstrate that intellectual capital disclosure affects the cost of equity capital. In addition, companies are motivated to report intellectual capital externally due to the belief that transparency enhances company value, leading to better evaluations by the capital market.

H1: Disclosure of intellectual capital influences the cost of equity capital.

Corporate Social Responsibility on the Cost of Equity Capital

Corporate Social Responsibility (CSR) has been recognized as a significant factor affecting the Cost of Equity Capital for companies in various industries. Numerous studies have examined the relationship between CSR practices and the cost of equity. It provides insights of the impact of ethical business behavior on financial performance. Another study by Ponto & Santoso (2019) also revealed that CSR has a positive effect on financial performance measures such as Return on Assets (ROA) and Return on Equity (ROE), but a negative impact on Cumulative Abnormal Returns (CAR). This indicates that, while CSR initiatives can improve profitability and efficiency, they may not always result in immediate market gains. Similarly, Ariyani & Nugrahanti (2016) investigated the impact of CSR disclosure on the Cost of Equity Capital, highlighting the importance of transparently communicating CSR activities to investors. Furthermore, Ofogbe et al. (2021) analyzed the influence of CSR on the Cost of Capital of companies listed on the Nigerian Stock Exchange, emphasizing the significance of CSR in shaping the overall cost of capital structure. Additionally, the disclosure of CSR practices can affect the cost of equity, indicating that stakeholders consider social responsibility efforts when evaluating a company's financial position.

Corporate social responsibility (CSR) encompasses a company's responsibility toward the cost of equity capital. Li & Liu (2018) state that fulfilling CSR obligations can lead to sustainable community development, enhanced public image, improved financial capabilities, and reduced cost of equity capital. Disclosing CSR activities in the company's annual report can enhance the company's reputation. Several studies, such as those conducted by Rianingtyas & Trisnawati (2017), Li & Liu (2018), and Hmaittane (2019), have demonstrated that CSR affects the cost of equity capital. In accordance with signaling theory, confidence is very influential in the stock market because CSR disclosure is expected to be able to provide signals and increase company value. Based on the arguments above, the hypothesis can be formulated as follows:

H2: Corporate social responsibility influences the cost of equity capital.

Quality of Earnings on the Cost of Equity Capital

The relationship between earnings quality and the cost of equity capital is explained through the theory of the pricing of information risk. Earnings reflect a good corporate performance within the business environment (Bekheet et al., 2019). Furthermore, performance reports such as earnings reports help align the interests of the company and investors concerning capital investment. Investors anticipate information risk by demanding a higher risk premium on the capital they invest in the company. This high-risk premium directly leads to higher capital costs for the company (Nasih et al., 2016). Assessing a company's performance requires information before investors decide to invest. This information must accurately reflect the company's actual condition to avoid disadvantaging investors and causing information asymmetry and information risk for the company (Babadi & Salehi, 2017).

According to Carvalho & Kalatzis (2018), the quality of a company's financial reports can be seen from the quality of accruals. Good accrual quality means that investors can understand the information provided by the company, allowing them to evaluate the company correctly and avoid information risk (Rachmawati, 2020). In this context, information risk in financial statements can occur because the accrual component of earnings recognizes revenue and expenses directly, leading to uncertain information (Yolanda & Mulyani, 2019). Researchers such as Efrina & Faisal (2017), Yolanda & Mulyani (2019), Dewanti et al. (2019), and Bekheet et al. (2019) have demonstrated that earnings quality affects the cost of equity capital.

H3: Earnings quality affects the cost of equity capital.

3. RESEARCH METHODS

Samples and Sampling Techniques

This research includes manufacturing companies in the consumer goods industry sector listed on the Indonesia Stock Exchange during the 2017-2021 period. The researchers selected the sample by using a purposive sampling method with specific criteria. The criteria used to determine the sample are as follows: the company must be listed on the Indonesia Stock Exchange during the 2017-2021 period, publish financial statements and annual reports as of December 31 for each year within that period, consistently record profits from 2017 to 2021, and provide complete information related to the variables used in this research. These criteria ensure that the selected sample is relevant and capable of providing the data necessary for research analysis.

Definition and Measurement of Variables

Cost of Equity Capital

According to Pramita (2016), the cost of equity capital is the economic consequence that a company must bear to obtain funds from investors to finance its operational activities. This cost of equity represents the rate of return expected by investors when they invest their money in the company. It also means that the cost of equity is the opportunity cost for investors. The measurement of the cost of equity capital can be calculated using the following formula:

$CEC = Rf + \beta\ (Rm - Rfm)$

Description:
CEC = Cost of equity capital
Rfr = Risk free rate
β = Unsystematic risk for each company's shares
MR = Market return
Description:
CEC = Cost of Equity Capital
Rf = Risk-based rate of return measured by government bond yield
β = company beta, which is a measure of the sensitivity of the company's stock returns to market returns.
Rm = market return which represents the average market return.

(Rm-Rf) = market risk premium, which is the difference between market returns and risk-free returns.

Disclosure of Intellectual Capital

Disclosure of intellectual capital, which is usually called ICD, is a disclosure of the value of intangible assets owned by a company because if an increasing number of companies go public, Disclosure of intellectual capital requires special attention, most of which are entities based on intellectual capital disclosure (Pangestika & Widiatmoko, 2021). Therefore, increasingly extensive disclosure of a company's intellectual capital can show that the company does not hide any information, so investor awareness of the risks that exist in the company is low. Intellectual capital is measured using the value-added intellectual coefficient (VAIC) developed by Pulic (2000). The following are the steps used to reveal intellectual capital, namely:

Step 1: Find and calculate the Value Added (VA) value
VA= OUT - IN

Description:
VA = Value Added
OUT = Output, is total income
IN = Input, are business expenses except employee salaries and benefits

Step 2: Find and calculate the value added of capital employed (VACA) or CEE.
Sutisna et al., (2023) tates that CE is a comparison between value added and the total amount of capital employed. VACA is a form of good ties between companies and business partners. To calculate VACA, use the formula, namely:
VACA = Value Added (VA) / Capital Employed (CE)

Description:
VACA = Value Added Capital Employed
VA = Value Added
CE = Available funds (equity, net profit)

Step 3 : Find and calculate the value of value added human capital (VAHU) or HCE.
VAHU indicates how large the quantity of VA is generated through funds/costs spent on employees. To calculate VAHU, use the formula, namely:
VAHU = Value Added (VA) / Human Capital (HC)

Description:
VAHU = Value Added Human Capital
VA = Value Added
HC = Labor expenses (total salaries, wages and employee income).

Step 4 : Find and calculate the value of structural capital value added (STVA) or SCE. STVA shows how much SC contributes to value creation. The formula for calculating STVA is:
STVA = Structural Capital (SC) / Value Added (VA)

Description:
STVA = Structural Capital Value Added
SC = *Structural Capital* firm (VA-HC)
VA = Value Added

Step 5: Find and calculate the value of relational capital and value added
RCE = Marketing Expenses / VA

Description:
BP = Marketing Expenses
VA = Value Added

Step 6: Find and calculate the value added intellectual coefficient (VAIC). VAICTM is the sum of VACA, VAHU, and STVA. VAICTM or human capital efficiency (HCE), structural capital efficiency (SCE), and relational capital efficiency (RCE), as well as the physical capital component, namely capital employed efficiency (CEE). VACI^{TM} calculated using the following formula:
VAIC^{TM} = HCE + SCE + RCE + CEE

Corporate Social Responsibility
Corporate social responsibility is a way to signal to investors about the company's condition, which helps to enhance the company's credibility and increase the value of its shares (Rianingtyas & Trisnawati, 2017). Researchers use the Global Reporting Initiative (GRI) standard, specifically the GRI-G4 standard, to assess corporate social responsibility disclosures, which they categorized into economic, environmental, and social aspects. The GRI-G4 standard consists of 91 disclosure items and uses a disclosure score to calculate corporate social responsibility (CSR) disclosure. They did it by using dummy variables, core 0: if the company does not disclose the items on the questionnaire, core 1: if the company discloses the items on the questionnaire. The formula used to reveal CSR after scoring on the Global Reporting Initiative index is based on research conducted by Dirman (2019).
CSRDI = $\sum$Xi / n

Description:
CSRDI = Corporate social disclosure index
$\sum$Xi = Number of items disclosed
n = Number of all items for the company

Earnings Quality
Earnings quality is a multifaceted concept that encompasses various accounting and financial factors, incorporating both qualitative and quantitative elements. It can be evaluated through an earnings management perspective, which involves the manipulation of financial reports to adjust, inflate, or deflate profits using accounting methods. The calculation formula for measuring earnings quality is as follows:

Table 2
Sampling Description

Information	Total	Percentage
Manufacturing companies in the consumer goods industry sector that were listed on the Indonesia Stock Exchange from 2017 to 2021.	77	100
Companies that did not publish financial reports and annual reports as of December 31 for the period spanning 2017 to 2021.	(25)	32,46
Companies that incurred losses between 2017 and 2021.	(12)	15,58
Companies that did not provide complete information about the variable requirements used.	(10)	12,98
Number of samples	30	38,98

Source: Processed Data

Table 3
Hypothesis Testing Results

Statistical test t		B	Sig	Hypothesis Results
Intellectual Capital Disclosure		-0,269	0,022	H_1 Accepted
Corporate Social Responsibility		0,227	0,031	H_2 Accepted
Quality of Earnings		-0,097	0,018	H_3 Accepted
Statistical test F		Coefficient of Determination Test		
F value	4.692	R Square		0.689
Sig	0.004[a.]	Adjusted R Square		0.069

Source: Processed Data

The researcher took the data for working capital accrual from cash flow reports related to operating activities. This enables investors to acquire the data directly without having to perform complex calculations.

4. DATA ANALYSIS AND DISCUSSION

The purposive sampling method obtained 30 samples based on specific criteria. Table 2 displays a 5-year observation period from 2017 to 2021; hence, the total sample processed in this research was 150 observations.

Hypothesis Testing Results

This research employed multiple linear regression analysis, and the results are presented in Table 3.

Intellectual Capital Disclosure of Cost of Equity Capital

The research findings indicate that intellectual capital disclosure has a significant negative effect on the cost of equity capital. A greater level of disclosure in both quantity and quality can reduce investor uncertainty regarding company risks, ultimately lowering the company's cost of equity capital. This conclusion is supported by various studies (Anggraeni & Indarti, 2021; Santoso & Deviyanti, 2022; Salvi et al., 2020; Mondal & Ghosh, 2020). The information provided through intellectual capital disclosure gives stakeholders a better understanding of the company's performance, enabling them to make more informed investment decisions. Additionally, companies with higher levels of intellectual capital disclosure benefit more than those that do not disclose, as it provides stakeholders with more relevant information and reduces the costs associated with personally gathering information. In summary, the research findings are crucial for both policymakers and companies, emphasizing the importance of intellectual capital disclosure in influencing the cost of equity capital.

Corporate Social Responsibility on the Cost of Equity Capital
Consequently, the second hypothesis posited in this research is upheld. It can be inferred that corporate social responsibility does indeed affect the cost of equity capital. Corporate social responsibility encompasses all activities related to a company's social and environmental concerns. The researchers believe that this fosters a positive image for the company, thereby contributing to the achievement of its goals. Implementing corporate social responsibility can enhance financial performance. Investors are inclined to invest in companies that prioritize corporate social responsibility, recognizing that such companies can utilize this social awareness as a competitive advantage. These research findings complement existing studies by Rianingtyas & Trisnawati (2017), Dirman (2019), Li & Liu (2018), and B. Chen & Zhang (2021) who also conclude that corporate social responsibility impacts the cost of equity capital. By implementing and disclosing corporate social responsibility initiatives in their financial reports, companies aim to bolster their reputation and elicit a positive response from the public and investors. Based on signaling theory, it shows that investor confidence significantly influences the stock market, as CSR disclosure is anticipated to provide signals that raise the value of the company.

Quality of Earnings to Cost of Equity Capital
According to signal theory, companies with good earnings quality are likely to provide signals to investors in the form of financial information to persuade investors and creditors to make decisions to invest capital and lend funds to the company, thereby increasing the cost of equity incurred by the company. The results of the research are consistent with previous studies (Yolanda & Mulyani, 2019; Dewanti et al., 2019; Rachmawati, 2020; Bekheet et al., 2019) which have shown that earnings quality influences the cost of equity capital. It emphasizes that the quality of earnings in financial reports must be good or reflect the actual state of earnings in the company's financial reports. Financial reports with poor earnings quality can lead to high costs of equity for the company. This underscores how better earnings quality in financial reports can increase investor interest and confidence, ultimately reducing the company's cost of equity (Dewanti et al., 2019).

5. CONCLUSIONS, IMPLICATIONS, SUGGESTIONS AND LIMITATIONS

This research has shown that disclosure of intellectual capital affects the cost of equity capital. It demonstrates that a high or low percentage of intellectual capital disclosure affects how investors perceive the company's transparency in communicating information about intellectual capital management. In essence, the cost of equity capital reflects the management's ability to evaluate the company's intangible assets through these disclosures. s. Therefore, the cost of equity capital, whether high or low, can be due to various factors. This implies that earnings quality, as a measure of company performance, may not be strong enough to serve as the sole basis for investor decision-making.

It is recommended that companies increase transparency in intellectual capital disclosure and improve financial reporting to help investors more accurately estimate risks, potentially lowering the cost of equity capital. Education and training for investors on the importance of intellectual capital and how to interpret its disclosure in financial reports are also necessary. Further research with larger samples and different methods is advised to explore other factors affecting the cost of equity capital, such as innovation and risk management. However, this study has limitations, such as a limited sample size, possibly non-comprehensive measures of earnings quality, and not including all relevant variables. The limited period of the study and unconsidered industry differences may also influence the results.

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