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Research paper

Environmental, social, and governance (ESG) disclosure and its impact on effective tax rate (ETR) in Malaysia

Nadiah Abd Hamid [1] *, Hakimah Aisyah Mohamad Taib [1], Rohaya Md. Noor [1], Roszilah Shamsuddin [1], Rohayu Yusop [1]

[1] *Faculty of Accountancy, University Technology MARA Shah Alam, Malaysia*
**Corresponding author E-mail: nadiah201@salam.uitm.edu.my*

Abstract

The disclosure of Environmental, Social, and Governance (ESG) practices has become the most recent trend in providing non-financial information regarding Corporate Social Responsibility (CSR) activities of the companies. There are many benefits associated with ESG disclosure including tax burdens reduction through the utilization of tax incentives, which resulting in low Effective Tax Rates (ETRs). In Malaysia, the ESG Index has been launched by Bursa Malaysia in December 2014 to measure the performance of Public Listed Companies (PLCs) demonstrating strong ESG practices. Therefore, the current study aims to examine the level of ESG disclosure among PLCs in Malaysia and its possible effect on ETR. The data from 34 PLCs in Malaysia has been gathered and analyzed using the descriptive, correlation, and regression analysis. Results found that all three dimensions of ESG disclosure are negatively correlated with ETR whereby only environmental disclosure significantly affect ETR. Thus, PLCs would benefit most from the environmental programmes in the form of tax savings, while low ETRs indicate the existence of aggressive tax planning activities.

Keywords: *Corporate Social Responsibility; Effective Tax Rates; Environmental; Social; and Governance (ESG).*

1. Introduction

In an effort for companies to serve the interests of their stakeholders, the disclosure of Environmental, Social, and Governance (ESG) information has become the current global trend in sustainability reporting since stakeholders are expecting greater transparency and responsibility from businesses. This is due to the fact that non-financial reporting could provide extra useful information to the stakeholders, especially investors, in addition to the information generated from financial reporting solely (Amran, Rosli, & Hassan, 2008). The ever growing market interest in non-financial information, particularly through ESG disclosure, is evidenced in a study by Eccles, Serafeim, & Krzus (2011) which reflected the increasing investors' concerns on Corporate Social Responsibility (CSR) as well as the growing use of ESG disclosure quality as a proxy for management quality.

Apart from that, there are various other benefits could be obtained from ESG disclosure. For instance, emphasizing on ESG could has demonstrable impact on overall organizational growth whether through new markets, new product development, lateral expansion, new customers, or new partnerships. (Exter, Cunha, & Turner, 2011). Furthermore, Exter et al. (2011) revealed that ESG practices could add value to the business by maintaining good corporate reputation and brand value, which consequently building stakeholders' trust with attracting customers as one of the results. This is in line with the findings from a study by Garcia (2014), which found that the reputational effects of CSR lead to increased effectiveness of corporate lobbying expenditures, therefore reducing the corporate actual tax burdens or known as effective tax rates (ETRs). Thus, it is discovered that the firms which are more socially responsible get a lower ETR than the firms which are less socially responsible, while lower ETRs suggest higher extent of corporate tax avoidance (Garcia, 2014; Huseynov & Klamm, 2012).

In collaboration with Financial Times Stock Exchange (FTSE), Bursa Malaysia Bhd has developed and announced the launch of the ESG Index in December 2014, which is known as the FTSE4Good Bursa Malaysia (F4GBM) Index (Bernama, 2014). According to Bursa Malaysia, the F4GBM Index is used to measure the performance of Public Listed Companies (PLCs) demonstrating strong ESG practices (Bernama, 2014). After a year since its launch, there are 34 PLCs included as the constituents of the F4GBM Index (Bernama, 2015). Since ESG initiatives in Malaysia are still relatively new, researches that study on the effect of the level of ESG disclosure on ETR are almost non-existent, despite the importance of ESG disclosure to cater the demand of information from the stakeholders. Besides, ESG disclosure could be one of the strategies used by the companies in tax planning. Hence, this study seeks to investigate the possible relationship between the level of ESG disclosure and ETR. Specifically, the objectives of the study are to examine the level of ESG disclosure for environmental, social and governance dimensions among PLCs in Malaysia and to determine the relationship between environmental, social and governance dimensions of ESG disclosure towards ETR. The findings from this study would provide new insight on the level of ESG disclosure among PLCs and contribute to the tax knowledge since companies will be able to avoid tax through the tax incentives as shown by the effects of ESG disclosure on ETR.

The rest of the paper is organized as follows. Section 2 provides a discussion on CSR and corporate tax aggresiveness, followed by a discussion on ESG and organizational performance in Section 3. While section 4 provides an explanation on ESG practices in Malaysia. In section 5, the research framework and hypotheses development are included, while section 6 present on the research and material of this study. The empirical results will be presented including the results of correlation analysis and regression analysis in section 7. The later part of this paper will be the conclusion of the study.

2. CSR and corporate tax aggressiveness

Even though there are criticisms that CSR conflicts with the primary objective of the company to maximize profits for its shareholders, proponents of CSR pointed that CSR would not necessarily conflict with such an objective (Fisher, 2014). This is because CSR covers the entire range of the company's responsibilities towards society including the economic, legal, ethical, and discretionary responsibilities (Renselaar, 2016). This is in line with the stakeholder theory which states that companies should serve all of their stakeholders including employees, communities, government, customers, and etc., rather than maximizing profits for the shareholders only (Freeman and Reed, 1983; Hoi, Wu, & Zhang, 2013). Therefore, Fisher (2014) explained that CSR provides a useful framework for evaluating corporate practices that do not necessarily align with the goal of profit maximization, but also include the consideration of social, environmental, and sustainability issues.

According to Renselaar (2016), the relation that exists between CSR and corporate tax aggressiveness is complex and conflicting. On one hand, tax avoidance can be seen as an economic responsibility which is part of CSR, since lowering the tax burden could reduce the costs of doing business, therefore improves the profitability (2016). On the other hand, tax avoidance could be regarded as socially irresponsible or costly to the society, since tax payments could help in funding the provision of public goods such as schools, defense, and health care, and due to tax avoidance practices may be harmful as legal activity of tax avoidance may shift into the illegal activity of tax evasion (Christensen & Murphy, 2004; Hoi et al., 2013; Dowling, 2014). In a study by Hoi et al. (2013), it is found that firms with excessive irresponsible CSR activities, which include the actions that are damaging to corporate governance, employee relations, communities, public health, human rights, diversity, the environment, and others, are more aggressive in avoiding taxes. On the contrary, Renselaar (2016) discovered that responsible companies with higher CSR score are involved in higher extent of corporate tax avoidance compared to less responsible companies.

3. ESG and organizational performance

There are three dimensions of ESG whereby all concerns regarding the natural environment and product and service quality belong to environment dimension, all concerns related to mankind or people belong to social dimension, and all concerns that can portray the sustainable performance of a company belong to governance dimension (Laguir, Stagliano, & Elbaz, 2015). Each dimensions of ESG could bring different impact to the organizational performance. For an example, Tarmuji, Maelah, & Tarmuji (2016) found the support that social and governance practices significantly influence the economic performance, whilst environmental practices not significantly influence the economic performances even though it is significant positively correlated with economic performance. The explanation to the findings is that management need to invest extra resources, including funds, technologies and human resources for environmental activities which consequently leading to additional costs (Tarmuji et al., 2016). On the other hand, good social practice could enhance the employment quality, health and safety, training and development, diversity, human rights, community and product responsibility, and a proper governance structure will provide an excellent support from the top management (Tarmuji et al., 2016).

In contradiction, Atan, Razali, Said, & Zainun (2016) found no association between ESG disclosure level and firm's financial performance. However, Nollet, Filis, & Mitrokostas (2016) asserted that ESG will positively affect the financial performance in the long run with governance as the key driver. This is supported by Kweh, Alrazi, Chan, Abdullah, & Lee (2017) since they discovered that governance improved firm efficiency based on the research conducted on Government-linked Companies (GLCs) in Malaysia. By contrast, social and environmental factors had no similar effects (Kweh et al., 2017). Overall, it could not be denied that emphasizing on all three dimensions of ESG could has positive impact on organizational growth, through many kinds of means such as through new customers and new markets (Exter et al., 2011).

4. ESG practices in Malaysia

In line with the Prime Minister's vision in Budget 2014, the ESG Index, F4GBM, has been launched by Bursa Malaysia in December 2014 in order to measure the performance of companies demonstrating strong ESG practices (Bernama, 2014). F4GBM was developed as part of the globally benchmarked FTSE4Good Index Series and aligned with other leading global ESG frameworks such as the Global Reporting Initiative and the Carbon Disclosure Project (Bernama, 2014). There are 34 PLCs included as the constituents of the F4GBM in 2015, and they need to meet internationally benchmarked criteria that measure efforts in environmental conservation, the initiatives of social responsibility, and the practice of good governance, once become a constituent (Bernama, 2014; Bernama, 2015).

5. Research framework & hypotheses development

Figure 1 represents the research framework of this study depicting the relationship between independent variables and dependent variable. The research framework attempts to explain the relationship between the three dimensions of ESG disclosure which are environmental disclosure, social disclosure and governance disclosure towards ETR.

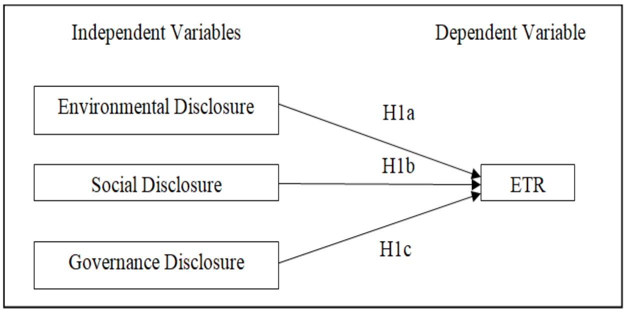

Fig. 1: Research Framework.

Since income taxes represent one of the costs of doing business, the differences between the actual tax burdens namely ETR and the statutory tax rate (STR) will be resulting in tax savings (Noor, Mastuki, & Bardai, 2008). Garcia (2014) explained that tax savings could bring financial benefits to the companies as it would constitute a cash inflow that increase net present value (NPV) of CSR investment. As evidenced by Garcia (2014), it could be expected that the more the firms engaging in sustainable practice, the lower the corporate ETR. This is in line with stakeholder theory which suggested that managers should act in the stakeholders' interests, whereby CSR activities will benefit society while low costs of doing business will benefit shareholders (Freeman & Reed, 1983).

In Malaysia, there are various financial incentives introduced by the Malaysian Government to certain environmental activities such as tax exemptions for property developers, stamp duty exemption for buyers of green buildings, and also income tax exemption and investment tax allowance (ITA) on qualifying capital expenditure incurred for renewable energy generation and energy conservation, waste recycling, handling and treatment of hazardous waste (Papargyropoulou, Padfield, Harrison, & Preece, 2012). Therefore, higher disclosure of ESG could reduce the corporate tax burdens through the utilization of tax incentives provided.

Apart from that, as revealed by Renselaar (2016), the firms that are more responsible and conduct more CSR activities tend to engage in more aggressive tax avoidance. The result from the research by Lanis & Richardson (2012) also showed a positive and statistically significant association between CSR disclosure and corporate tax aggressiveness, showing that firms that disclose more on CSR activities resulted in lower ETRs. Since lower ETRs reflected higher extent of tax avoidance, it could be expected that the companies that disclose more on ESG will pay lower taxes.

According to Laguir et al. (2015), the dimensions of corporate social responsibility should not be aggregated into a single measure in order to prevent the loss of interesting and explanatory information. Thus, ESG disclosure is separated into its three respective dimensions and the hypotheses are developed as follows:

H1: ESG disclosure will significantly affect ETR
H1a: Environmental disclosure will significantly affect ETR
H1b: Social disclosure will significantly affect ETR
H1c: Governance disclosure will significantly affect ETR

6. Research methodology

This study used quantitative research strategy to figure out the relationships between variables. The sample companies are the 34 PLCs included as the constituents of the F4GBM index in 2015. The data that were used for this study is secondary data collected from the annual report and the company's discrete reporting such as CSR, sustainability, governance, environmental and other relevant reporting obtained from Bursa Malaysia and the company's website.

The independent variables in this study are the three dimensions of ESG disclosure which are environmental, social, and governance dimension that are measured by relevant items representing each dimensions. On the other hand, the dependent variable in this study is the ETR. Since ETRs measure the efficiency of a corporation in mitigating its current tax liability related to its pre-tax accounting income, ETRs stipulate the relative tax burden across corporations (Rego, 2003). Not only that, ETRs calculation is one of the widely used method in determining corporate tax aggressiveness, therefore ETRs determine the extent of tax avoidance of the firms (Lanis & Richardson, 2012; Hope, Ma, & Thomas, 2013).

The data has been analysed using Statistical Package for Social Science (SPSS) program for Windows Software version 23.0. The descriptive analysis has been obtained for the independent variables to identify the level of ESG disclosure among the PLCs. The correlation analysis has been used in an effort to explore the relationships between the variables. Meanwhile, regression analysis is used to determine the effects of independent variables which are the three dimensions of ESG disclosure, on the dependent variable which is ETR.

7. Empirical results

The first objective of this study, i.e. to examine the level of ESG disclosure for environmental, social and governance dimensions among PLCs in Malaysia, is fulfilled by analyzing the ESG disclosure among the 34 PLCs included as the constituents of the F4GBM Index. The statistical information are shown in Table 1.

Table 1: Summary Statistics

Statistics	Mean	Minimum	Maximum
Environmental Disclosure	8.77	0.00	14.00
Social Disclosure	11.35	6.00	17.00
Governance Disclosure	10.15	5.00	12.00

There are 14 items represent the environmental disclosure, 17 items represent social disclosure, and another 12 items represent governance disclosure. Based on Table 1, overall, in each of the dimensions of the ESG disclosure which are environmental disclosure, social disclosure, and governance disclosure, there are PLCs that are able to disclose all the items listed. However, by observing the least score in each of the dimensions, there are PLCs that do not disclose any information at all regarding environmental, and disclose less than half items for social and governance.

For environmental disclosure, most of the PLCs provide information on initiatives for energy resources efficiency and reduction and policy on recycling and waste management. Meanwhile, less companies provide information regarding renewable energy resources. As for social disclosure and governance disclosure, the full score were obtained for involvement of stakeholder through communication in social dimension and disclose board information in governance dimension. This means that all the 34 PLCs provide information regarding those matters. On average, PLCs in Malaysia disclose 9 items for environmental (mean=8.77), 11 items for social (mean=11.35), and 10 items for governance (mean=10.15), which means that the companies are disclosing more than half of the items in each dimension of ESG disclosure.

In order to achieve the second objective of this study, a correlation analysis is carried out to determine the relationship between environmental disclosure, social disclosure, and governance disclosure towards ETR. Table 2 shows that only relationship between environmental disclosure and ETR is significant at the .05 ($p = .011$, $p < .05$). In determining the direction of the relationships, all three dimensions of ESG disclosure are negatively correlated with ETR, which means that an increase in ESG disclosure is associated with a decrease of ETR, and vice versa. Based on the coefficient value of r, the relationship between environmental disclosure and ETR is low, while the relationships between social disclosure and governance disclosure towards ETR are little (Hinkle, Wiersma, & Jurs, 1998).

Table 2: Summary Statistics of Correlation Analysis

Independent Variables	Effective Tax Rate	
	Pearson Coefficient of Correlation (r)	p-value
Environmental Disclosure	-0.351	0.011*
Social Disclosure	-0.118	0.406
Governance Disclosure	-0.212	0.131

* Significant at 0.05.

Next, to determine the causal-effects relationship between the variables, a regression equation was estimated with environmental disclosure, social disclosure, and governance disclosure as the independent variables and ETR as the dependent variable. Table 3 presents the summary statistics of the estimated regression equation.

Table 3: Estimated Regression Equation

Variable	Coefficient	t-value	p-value
Environmental Disclosure	-0.015	-2.650	0.011*
Social Disclosure	-0.044	-0.322	0.749
Governance Disclosure	-0.105	-0.745	0.460
F	7.024		0.011*
R^2	0.646		

* Significant at 0.05.

The regression equation is statistically significant at .05 ($p = .011$, $p < .05$), implying that there is an association between any or all of the independent variables and ETR. The R-square value being 0.646 means that the three independent variables as a whole account for 64.6 % of the variation in the dependent variable. Hence, the effect of environmental disclosure, social disclosure and governance disclosure as a whole on ETR is moderate (Hair, Sarstedt, Hopkins, & Kuppelwieser, 2014). By looking at the individual regression coefficient, it is found that only the coefficient of environmental disclosure is statistically significant at .05 ($p = .011$, $p < .05$), whereas those of social disclosure and governance disclosure are not significant. Hereby, H1 is partially supported since only H1a is supported, while H1b and H1c are not, showing that only environmental disclosure significantly affect ETR. Table 4 below shows the results. The coefficient of environmental disclosure being negative (-0.015) means that an increase in environmental disclosure decreases ETR, while changes in the other two variables have no impact at all on ETR.

Table 4: Results of Hypotheses Testing

Hypotheses	Results
H1: ESG disclosure will significantly affect ETR	Partially Supported
H1a: Environmental disclosure will significantly affect ETR	Supported
H1b: Social disclosure significantly affect ETR	Not supported
H1c: Governance disclosure will significantly affect ETR	Not supported

8. Conclusion

From the results of the analysis, it could be observed that ESG disclosure significantly affect ETR, specifically through the environmental disclosure. It could be understood that the more the companies disclose on environmental in their sustainability report, the lower the tax burdens of the companies, which measured by ETR.

The underlying reasons could be due to the tax incentives provided by the Malaysian Government for specific environmental activities in an effort to promote sustainability among the companies in Malaysia. The more the corporates investing and emphasizing on environmental programmes, the more the corporate tax burdens could be reduced in the form of tax exemptions or ITA through the utilization of tax incentives. The findings also evidenced the existence of aggressive tax planning activities used by the companies. Companies could involve in tax avoidance through the utilization of tax incentives.

Nevertheless, from the results obtained previously, it is unveiled that there are PLCs that do not disclose any information regarding its environmental activities, even though the overall ESG disclosure among Malaysian PLCs indicate sufficient information provision since the companies are disclosing more than half of the items in each dimensions of ESG and the presence of full scorer in each dimensions. Thus, in connection with the findings of this study, the importance of ESG disclosure should never be taken for granted by the companies in Malaysia, especially PLCs, in order for them to improve their competitiveness and contribute to the economic growth of the nation for certain.

Not only companies could receive financial benefits through the tax savings resulting from the lower rate of ETR of the businesses, the benefits of the ESG disclosure would definitely cater the needs of the important stakeholders by providing substantial insights for crucial decision making process. However, tax authorities need to take the findings into consideration since it provide insight on strategies for tax avoidance. The results from this study also important for future research on tax aggressiveness.

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