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The Relationship between Corporate Social Responsibility Disclosure and Earnings Management: Is it a Complement Mechanism or a Substitute Mechanism?

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paper text:

17**The relationship between corporate social responsibility** disclosure **and earnings management:**

Is it a complement mechanism or a substitute mechanism? Abstract: Prior literature has provided inconclusive results concerning the

22**relationship between corporate social responsibility** disclosure (CSRD) **and earnings management** (EM). **This study examines the** relation **between**

CSRD and EM. For this study, 479 annual reports of publicly listed Indonesian companies were selected as the sample. The two-stage least square (2SLS) method was employed to test the relationship between CSRD and EM. Our findings suggest that companies that have high CSRD are less likely to manage earnings. Moreover, our findings suggest that the relationship between CSRD and EM can be viewed as a substitute mechanism.

14**This study** contributes **to the** accounting **literature by** examining **the relationship between** CSRD **and**

EM

10**in the** setting **of an emerging** country. Keywords: **corporate social responsibility,** earnings management, real activity, disclosure, two-stage least square, Indonesia 1 Introduction A company is required to generate profits; however, it also has a responsibility to the communities and environment where it operates. One way to be responsible is to provide stakeholders with information regarding the company's corporate social responsibility (CSR) activities through disclosure. Ideally, corporate social responsibility disclosure (CSRD) is considered to be an accountability tool that provides transparent and reliable information to all stakeholders (Kim et al., 2012). However, in providing the information, companies may only have opportunistic incentives (McWilliams & Siegel, 2000; Pyo & Le, 2013).

7**If managers engage in** and disclose **CSR** activities **based on opportunistic incentives, then they are likely to mislead stakeholders** about **the value of the firm and** its **financial performance**

(Kim et al., 2012). Previous studies have suggested that managers may participate in CSR activities to cover the corporation's illicit activities (Hemingway & Maclagan, 2004); one of the illicit activity is earnings management (EM) practices (Grougiou et al., 2014). Prior studies have argued that companies that perform EM tend to compensate for this action by performing more CSRD. Prior et al. (2008) argued that managers that have incentives to manage earnings tend to be more aggressive in the disclosure of CSR activities in order to maintain their reputation. Choi et al. (2013) argued that, to maintain the success of a business, managers that perform EM will invest more of their funds in CSR activities to keep their opportunistic behaviour from being detected—while maintaining the company's legitimacy.

2**The objective of this study is to examine the** relationship **between** CSRD **and**

EM. Specifically, this study examines whether CSRD can limit the practice of EM and whether firms that managed their earnings will disclose more about their CSR activities. Prior studies have provided mixed conclusions regarding the relationship between CSRD and EM. Some researchers have argued that CSRD is a determinant of EM (see, for example,

9**Chih et al., 2008; Hong & Andersen, 2011; Kim et al., 2012;**

Scholtens & Kang, 2013; Litt et al., 2014; Muttakin et al., 2015), while other studies have stated that EM is positively associated with CSRD (see, for example, Prior et al., 2008; Choi et al., 2013). Based on the literature, disclosure has an important function in providing financial reports. In providing the information, it requires companies to be more transparent, and therefore it could limit opportunistic behaviours, such as EM practices. However, CSRD could also be used as a tool to cover up EM practices. The relation between CSRD and EM might be endogenous, raising doubts about the explanation of causality. Thus, there is room for this study to further examine the relationship of these two variables. As an emerging country, Indonesia represents an interesting case when exploring the practices of CSRD and EM. Some studies show that CSR practice in Indonesia has been increasing (Siregar & Bachtiar, 2010). CSR activities have become more prominent since the government issued new legislation, namely Company Law Number 40 (2007). According to the law, companies that operate in the natural resources sector must report their CSR activities in annual reports. However, CSRD practices in annual and/or sustainability reports are still in their infancy, being mostly descriptive (Gunawan, 2007; Mirfazli, 2008; Cahaya et al., 2012; Djajadikerta & Trireksani, 2012). In the context of financial reporting's transparency, a survey by the Asian Development Bank (ADB) in 2014 concluded that disclosure and transparency

15**were poorly implemented by some** Indonesian **publicly listed companies (PLCs).**

Though

15**corporate governance performance improved significantly in 2013 compared to 2012,**

the performance was still unsatisfactory compared to other ASEAN countries (Asian Development Bank, 2014).

5**This study contributes to the literature in several ways. First,** the **research**

provides further evidence on the relationship between CSRD and EM practices in an emerging country. Most previous studies on this topic have been conducted in developed countries, such as the United States (Hong &

9**Andersen, 2011;** Yip **et al.,** 2011; **Grougiou et al., 2014)**

or the United Kingdom (Sun et al., 2010). Some studies have even used international data (Chih

8**et al.,** 2008; **Prior et al., 2008;** Surroca & Tribó, 2008; **Kim et al., 2012;**

Scholtens & Kang, 2013; Litt et al., 2014; Martínez-Ferrero et al., 2014; Martínez-Ferrero et al., 2015). Second, this study examines the simultaneous relationship between CSRD and EM. There are few studies that have been conducted in the setting of emerging countries (see, for example, Choi et al., 2013). By focusing on an emerging country, this study can reduce the potential bias in the estimation and misinterpretation of the results by clarifying whether CSRD determines EM practices or vice versa. Third, most prior studies have viewed the relationship between CSRD and EM through the agency theory lens. This study employs the stakeholder

> 13-**agency theory. Agency theory has been** widely **used in** the **literature to explain**

the relationship between disclosure and EM. The main focus of

> 25**agency theory is** explaining **the relationship between the** agent **and the** stockholders. However, **the** nature **of**

contractual relationships between firms and stakeholders, such as in the CSRD and EM context, has not been explored (Hill & Jones, 2002, p. 131). Thus, this study can provide additional insights into how stakeholder-agency theory explains the relationship between CSRD and EM. 2 Literature review 2.1 Stakeholder-agency theory Stakeholder-agency theory (SAT) was derived from stakeholder theory and agency theory. Hill & Jones (2002) proposed this paradigm to help explain: certain aspects of firms' strategic behaviours, the relationships between

> 6**the structure of management** and **stakeholder contracts, the form taken by institutional structures that monitor and enforce contracts between managers and other stakeholders, the evolutionary process that shapes management- stakeholder contracts, and the institutional structures that police those contracts.**

SAT not only considers a firm to be a nexus of contracts between a shareholder, but it also

> 13**encompasses the implicit and explicit contractual** relationship **between all stakeholders**

(Hill & Jones, 2002, p. 132). Furthermore, they explain that, in terms of SAT, managers have a unique role model (which is not only the agent of the firm's principal but also the agent of other stakeholder). The agency theory has explained that the principal hires the manager to conduct duties and rewards the manager when the duties are completed. In this case, however, the manager is only hired by the firm. Despite that, there is an association between the stakeholder-agent relationship and the principal-agent relationship, which involves an implicit and explicit contract to accommodate different interests (Hill & Jones, 2002, p. 134). Managers not only have a relationship or association with the business owners or shareholders but also with other stakeholders in the company (Prior et al., 2008, p. 162). . 2.2 CSRD and EM Prior literature has provided inconclusive results concerning the relationship between CSRD and EM. Choi et al. (2013) argued that there are two competing views of the relationship between EM and CSRD. First, based on long-term perspective motivation, the provision of earnings quality information is closely related to CSR activities. In this context, CSRD can be used by companies as a medium to meet the stakeholders' expectations for the company's sustainability. By engaging in CSR activities, companies can maintain good relations with stakeholders. Second, from the perspective of opportunistic behaviours, CSR activities may be used by managers as an entrenchment strategy. Under this strategy, the

> 4**'manager believes that by satisfying stakeholders' interests and projecting an image of social and environmental concern and awareness, he can reduce the likelihood of being scrutinized by satisfied stakeholders for his management of earnings' (Prior et al., 2008,**

p. 162) 2.2.1 The negative relation between CSRD and EM In the context of SAT, CSRD activities are seen as an effort to maintain the company's good relations with stakeholders, such as shareholders, employees, customers, suppliers, and communities. Thus, companies that engage in CSRD activities have a strong incentive to not engage in EM. The misalignment occurs because the CSRD activities focus on efforts to meet the stakeholders' expectation and to increase the value of the company, whereas EM may decrease the satisfaction of the stakeholders due to actions that distort the company's normal operating cycle and lead to a decline in the value of the company (Cho & Chun, 2015). Companies with higher social responsibility are more ethical in their reporting behaviours with less accounting manipulation. As a result, smoothed earnings from high-CSR firms deviate less than 'undistorted' earnings; thus, smoothed earnings are more value relevant and lead to a better valuation of the companies (Gao & Zhang, 2015, p. 109).

> 23**Using a sample of 139** firms **in 10 Asian countries, Scholtens & Kang (2013)**

studied how earnings smoothing and earnings aggressiveness are associated with CSRD. Their main result suggested

8that firms with good CSR are less likely to manage earnings.

A negative relationship between CSRD and EM is consistent with Litt et al. (2014), who found that firms with an environmental initiative have lower discretionary accruals. Also, Hong &

9Andersen (2011), Kim et al. (2012), and Choi et al.

(2013) argued

8that CSR firms are less likely to engage in aggressive

EM. 2.2.2 The positive relation between CSRD and EM Based on the stakeholder-agency perspective, EM allows managers to look for their own interests. The consequence of this is that it will not only be detrimental to others (especially the key stakeholders), but it will also have a negative effect on the company's financial performance if EM practices continue for a long time. To avoid the negative consequences of EM practices, managers may adopt CSR practices that can satisfy the various interests of the stakeholders. In this sense, CSR can be viewed as a strategy to meet the demands of stakeholders

10(Prior et al., 2008). In other words, managers who participate in EM try to

compensate for those practices by implementing CSR. Grougiou et al. (2014) noted that companies that engage in EM practices are also more likely to be involved in CSR. Though they found that firms that participated in EM tended to be more involved in CSR activities, the relationship between CSRD and EM was not statistically significant. More recently, Muttakin et al. (2015) provided an evidence that managers had managed earnings also provided higher CSRD. The existence of a

24positive relationship can be explained by the fact that the managers have the purpose of obtaining the

support of stakeholders, which reduces the risk of experiencing the negative impact of EM practices (Martínez-Ferrero et al., 2014). H1: Corporate social responsibility disclosure is associated with earnings management. 2.3 EM and CSRD Some prior studies have also investigated whether EM practices are influenced by the level of CSRD. Prior et al. (2008) examined the relationship between EM and CSRD. They used income smoothing practices to measure EM. The sample of their studi is 593 companies from 26 countries. Their study found that there is a positive relationship between EM and CSRD. Consistent with Prior et al. (2008), Choi et al. (2013) examined the relationship between EM and CSR in 2,042 Korean firms listed on the Korea Exchange from 2002 to 2008. They used the

14absolute value of abnormal discretionary accruals from the modified Jones models to

measure EM, while CSR activities were measured by an index published by the Korea Economic Justice Institute (KEJI). Their result showed that firms with high earnings also had a better CSR ratings. H2: Earnings management is associated with corporate social responsibility disclosure.

283 Research method 3.1 Data and sample selection This study used a sample

of 479 PLCs

29in the Indonesia Stock Exchange (IDX) during the period from 2012 to 2013.

CSRD was collected from companies' annual reports, and financial data were gathered from the Bloomberg databases.

12Table 1 presents the sample selection of this study. Table 1 Sample selection

Criteria 2012 2013 Total company listed on Indonesia Stock Exchange (IDX) Companies include in financial sectors Companies did not provide CSR information in annual reports Total sample = 479 463 (102) (126) 235 486 (102) (140) 244 3.2 Variables and measurement 3.2.1 EM Schipper (1989, p. 92) defined EM as 'an effort to intervene in the process of preparation of external financial reporting in order to gain personal benefits'. Consistent with Kim et al. (2012), this study used real activities manipulation to measure EM practices. Real activities manipulation also defined as 'a deviation from normal operational practice which is driven by the

18managers' desire to mislead at least some of the stakeholders in order to believe that the purposes of certain financial reporting has been fulfilled in normal operations' (Roychowdhury, 2006, p. 337). Three measures to detect real activities manipulation are: the level

21**of abnormal operating cash flow, abnormal production costs, and abnormal discretionary** load. Table **2** exhibits **the** measurement **of**

variables. 3.2.2 CSRD Guthrie & Matthews (1985) defined CSRD as

19**the provision of** information **(both financial and non-financial)**

about an organization's interaction with its physical and social environment (including the environment, human resources, products, and society) as stated in corporate annual reports or standalone reports. Consistent with previous studies of CSRD, a content analysis method was used to extract the information of environmental impact, labour practices, product responsibility, human rights, product responsibility, and social aspects from the reports. The measurements of CSRD were items adopted from the Global Reporting Initiative version G.3.1. There were 74 items (30 environmental items, 14 labour practice items, 11 human rights items, 10 social items, and nine product responsibility items). Table 2 provides a summary of the measurement of variables. Table 2 Summary of the measurement of variables Variable Measurement CSRD CSRD index = number of items disclosed divided by total items. The GRI G3.1 version is used as disclosure items. Of six themes, only 5 categories are used (economic theme was excluded). The score 1 will be given if item disclosed and 0 if not disclosed. RAM

1**CFOt/At-1 = α0 + α1 (1/At-1) + β1 (St/At-1) + β2** (ΔSt **/At-1) + εt** (1) COGSt / **At-1** = α0 + α1 **(1/At-1)** + β1 **(St/At-1)** + εt (2) ΔINVt/ **At-1**

=

1**α0 + α1 (1/At-1) + β1** (ΔSt **/At-1) + β2** (ΔSt-1 **/At-1) + εt** (3) PRODt/ **At-1** = α0+α1 **(1/At-1)+** β1 **(St/At-1)+** β2(ΔSt/At **-1)+** β3(ΔSt **-1/**

At-1)+εt (4)

20**DISEXPt/ At-1 = α0 + α1(1/At-1) + β1(St-1/At-1) + εt**

(5) RAM = AB_CFO – AB_PROD + AB_DISEXP (6) CFOt = firm's operational cashflow on year t At-1 = firm's total asset on previous year St = firm's net sales on year t ΔSt = firm's change in net sales on year t εt = firm's abnormal operational cashflow on year t (AB_CFO) COGSt = cost of goods sold on year t ΔINVt = changes in inventory on year t PRODt = cost of production on the year t εt = abnormal production cost (AB_PROD) DISEXPt = discretionary load on the year t (sum of RnD expenses; advertising expenses; and sales expenses and administration) εt = abnormal discretionary load (AB_DISEXP) FIRM Market

16**value of equity LEV Long-term debt divided by total assets ROA** Earnings **after tax divided by total assets**

26**MTB Market value of equity divided by book value of equity**

CSRD = corporate social responsibility disclosure; RAM = real activities manipulation; FIRM = firm size; LEV = leverage; ROA=

3**return on assets; = MTB = market-to-book** of equity **ratio**

3.3 Analysis A two-stage least square (2SLS) analysis gives a more consistent and efficient estimation than ordinary least squares (OLS). A simultaneous relationship occurs when the endogenous repressor variables are correlated with the error or disturbance. The Hausman specification test was conducted before running the 2SLS analysis. RAMi,t = β0 + β1CSRDi,t + β2FIRMi,t + β3LEVi,t + β4ROAi,t + εi,t CSRDi,t = β0 + β1RAMi,t + β2FIRMi,t + β3MTBi,t + εi,t 4 Findings (1) (2)

27**Table 3 presents** the **descriptive statistics of the** 479 **sample** companies. **The** CSRD index's **mean**

is 13.4% with a minimum value of 1.3% and a maximum value of 94.7%. This mean indicates that the extent of companies' CSRD is still low. With respect to the real activities manipulation (RAM) variable, the maximum (minimum) value is 2.633 (-2.458). The mean (minimum; maximum) of RAM is 0.000 (-2.458; 2.633); this indicates

7**that, on average, firms do not seem to engage in**

RAM. The

12**descriptive statistics of** the **control variables are as follows: The**

mean (standard deviation) firm size was 28.017 (2.063), suggesting that most firms are relatively large; the leverage was 0.166 (0.178), suggesting that most firms are low in debt; the ROA was 0.050 (0.513), indicating that most firms are low in profitability and the market-to-book (MTB) equity ratio was 3.162 (8.926) indicating that most firms are low performance in market value of equity.

30**Table 3 Descriptive statistics Variable N Minimum Maximum Mean SD**

CSRD 479 .013 .947 .134 .097 RAM 479 -2.458 2.633 .000 .517 FIRM (log) 479 20.086 33.376 28.017 2.063 LEV 479 .000 1.790 .166 .178 ROA 479 -10.900 .620 .050 .513 MTB 479 -54.148 151.236 3.162 8.926 CSRD = corporate social responsibility disclosure; RAM = real activities manipulation; FIRM = firm size; LEV = leverage; ROA=

3**return on assets; = MTB = market-to-book** equity **ratio The**

purpose of conducting a simultaneous testing was to examine whether the endogenous variable was correlated with the error or disturbance. A simultaneous testing can be carried out after the assumption of Hausman specification is met.

5**Table 4 shows the result of the** Hausman **test.**

The results show that the unstandardized residual coefficient is significant at a level of 0.050, which means that there is a simultaneous relationship between RAM and CSRD. Thus, the 2SLS method can be used to estimate the consistency and efficiency. The result shows that the F-value is 7.121 with a significance level of 0.000. Thus, it can be concluded that RAM acts as an endogenous variable. Table 4 The result of the Hausman test Variable Coefficient t Sig. CSRD -12.446 -2.000 .046 FIRM .219 2.646 .008 LEV .573 2.160 .031 ROA .097 2.143 .033 Unstandardized residual 12.148 1.950 .050 F-test = 7.121 p-value = .000 Dependent variable: RAM = real activities manipulation; independent variables: CSRD = corporate social responsibility disclosure; FIRM = firm size; LEV = leverage; RoA=

3**return on assets; = MTB = market-to-book** equity **ratio;**

unstandardized residual Table 5 presents the results of the 2SLS. In Model (1), the coefficient of the unstandardized predicted value of CSRD is significantly negative (-12.446); this suggests

11**that companies with higher** CSRD **are more** ethical and less **likely to** participate in **the** manipulation **of**

accounts. H1 is supported. Therefore, CSRD may be seen as a substitute mechanism rather than a complement mechanism. This finding is consistent with Kim et al. (2012), Hong & Andersen (2011),

18**Cho & Chun (2015),** and **Choi et al. (2013).** Model (2) presents **the** result **of**

the regression with CSRD as the dependent variable. The coefficient of the unstandardized predicted value of RAM is positive but insignificant (0.060), indicating that RAM does not have an effect on the extent of CSRD. Thus, H2 is rejected. Although the results of the Hausman test showed a simultaneous relationship between CSRD and EM, the findings of this study provided empirical evidence that companies with higher disclosed CSR activities are not statistically significantly related to a company's engagement in EM activities. This finding does not support

10**the studies of Choi et al. (2013)** and Prior **et al.**

(2008). Table 5 Two-stage least square: the relation between CSRD and EM Model (1) Model (2) Constant RAM CSRD FIRM LEV ROA MTB -4.571 (-2.997)*** -0.157 (-1.027) - 0.060 (0.632) -12.446 (-1.999)** - 0.219 (2.645)*** 0.010 (1.940)* 0.573 (2.159)** - 0.097 (2.142)** - - -0.001 (-1.078) F-test (p-value) 8.523 (0.000) 14.026 (0.000) N R2 479 479 0.0670 0.081 CSRD = corporate social responsibility disclosure; RAM = real activities manipulation; FIRM = firm size; LEV = leverage; ROA=

3**return on assets; = MTB = market-to-book** of equity **ratio.**

*, **, ***

2**indicate significance at the 0.10, 0.05, and 0.01 levels, respectively (two-tailed).**

Model (1): Dependent variable is RAM; Independent variables are Unstandardized Predicted Value of CSRD, FIRM, LEV, ROA Model (2): Dependent variable is CSRD; Independent variables are Unstandardized Predicted Value of RAM, FIRM, and MTB 4.1 Sensitivity test The sensitivity analysis was conducted to test whether the result of the 2SLS was consistent; this was done by using another measurement of CSRD (namely environmental disclosure). Table 6 presents the result of the Hausman specification model test. The results show that the unstandardized residual coefficient is significant at a level of 0.048,

11which means that there is a simultaneous relationship between RAM and environmental disclosure. This finding is consistent with the

main analysis. Table 6 The result of the Hausman test Variables Coefficient t Sig. ENVDISC -30.183 -2.539 .046 FIRM .323 2.403 .017 LEV .543 2.152 .032 ROA .239 2.708 .007 Unstandardized residual 29.883 1.979 .048 F-test = 7.099 p-value = .000 Dependent variable: RAM = real activities manipulation; independent variables: ENVDISC = environmental disclosure;; FIRM = firm size; LEV = leverage; ROA= return on assets; = MTB =

17market-to-book equity ratio Table 7 presents the results of the

2SLS analysis. The result

19is consistent with the main result, which shows that

companies with more disclosed environmental information are more likely to not engage in EM. Table 7 Two stage least squares (2SLS): the relation of environmental disclosure and earnings management Independent variables Model (1) Model (2) Constant RAM ENVDISC FIRM LEV ROA MTB -7.258 (-2.538)*** - -30.183 (-1.999)** 0.323 (2.402)** 0.543 (2.151)** 0.239 (2.707)*** -0.085 (-0.585) 0.070 (0.779) - 0.005 (1.045) - - -0.001 (-0.813) F-test (p-value) 8.523 (.000) 7.041 (.000) N 479 479 R2 0.067 0.043 ENVDISC = environmental disclosure; RAM = real activities manipulation; FIRM = firm size; LEV = leverage; ROA=

3return on assets; = MTB = market-to-book of equity ratio.

*, **, ***

2indicate significance at the 0.10, 0.05, and 0.01 levels, respectively (two-tailed).

Model (1): Dependent variable is RAM; Independent variables are Unstandardized Predicted Value of environmental disclosure, FIRM, LEV, ROA Model (2): Dependent variable is environmental disclosure; Independent variables are Unstandardized Predicted Value of RAM, FIRM and MTB 5 Conclusions

5This study aimed to examine the relationship between CSRD and EM. The result of

this study provides empirical evidence that CSRD has a negative association with engaging in EM. The result is robust when we retest using another measure of CSRD (namely environmental disclosure). Our finding supports the hypothesis that companies that participate in CSRD are more inclined to meet the demands of their stakeholders by developing a good relationship with them. One of the ways to boost good relations is to maintain the accountability and

5the quality of financial reporting, which increases the value of the company. Based on the result, it can

be concluded that the relationship between CSRD and EM acts as substitution mechanism. The result is consistent with SAT; the contract of the relationship is not only between the company and shareholders but also with all of the stakeholders. This study had several limitations. First, this study did not consider the influence of several variables, such as industry and ownership type. In addition, the Indonesian government's regulations for CSR requires companies in high-profile industries such as mining to report their CSR activities. Such a regulation may affect companies' motivation for participating in CSRD. Results may differ as most of Indonesia's companies are owned by families. Although this study had limitations, the results provide implications both in theory as well as for management in practice. The results of this study show that, although a company might participate in more CSR activities, maintaining honesty and trustworthiness in financial reporting is still a priority. References Asian Development Bank. (2014), "ASEAN corporate governance scorecard: Country reports and assessments 2013-2014", in. Asian Development Bank Publication. Cahaya, F.R., Porter, S.A., Tower, G. and Brown, A. (2012) 'Indonesia's low concern for labor issues', Social Responsibility Journal, Vol. 8 No. 1, pp. 114-132. Chih, H.-L., Shen, C.-H. and Kang, F.-C. (2008) 'Corporate social responsibility, investor protection, and earnings management: Some international evidence', Journal of Business Ethics, Vol. 79 No. 1-2, pp. 179-198. Cho, E. and Chun, S. (2015) 'Corporate social responsibility, real activities earnings management, and corporate governance:

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