The Relationship of Corporate Social Responsibility (CSR) Disclosure and Earnings Management: Evidence from Indonesia

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Abstract

The relationship between corporate social responsibility (CSR) and earnings management is still a debate. Several previous studies showed that CSR is a determinant of earnings management. Meanwhile, others revealed the reverse. Therefore, this study aims to investigate the effect of CSR disclosure on earnings management and the effect of earnings management on CSR disclosure. This study was conducted with mining companies listed on the Indonesia Stock Exchange (IDX) in the 2016-2019 period. The research data was analyzed using multiple linear regression analysis. The data is obtained from financial statements, annual reports, and sustainability reports. The results reveal that there is a positive relationship between CSR disclosure and earnings management. This study also shows that the relationship model of CSR disclosure and earnings management is recursive. This finding implies that CSR disclosure is a tool used by management to cover up unethical actions from stakeholders. These results verify the agency theory and opportunist hypothesis regarding the relationship between CSR and earnings management. The novelty of this study lies in highlighting the recursive model of the relationship between CSR and earnings management.

Keywords: Corporate Social Responsibility Disclosure, Earnings Management, Recursive Model

JEL Classification Code: M14, M41, Q56

1. Introduction

Law No. 40 of 2007 concerning Limited Liability Companies regulates that Indonesian firms that carry out their business activities in and related to natural resources must carry out social and environmental responsibility. Even so, the implementation of these regulations is still very minimal. Cases of exploitation of natural resources and environmental pollution have increased in Indonesia (Rokhmawati & Gunardi, 2017). Besides, the absence of standards regulated by law regarding the format of corporate social responsibility (CSR) reporting also makes the quantity and quality of CSR reporting still vary in Indonesia (Muliati et al., 2020; Ridho, 2017; Ridwan & Mayapada, 2020).

CSR is represented as an ethical act by the company to all stakeholders, namely investors, creditors, employees, suppliers, customers, government, society, and the surrounding environment. The concept of CSR based on stakeholder theory stated that the firm should accommodate all stakeholder interests to ensure operating activities’ sustainability. Based on this concept, reliable financial reporting is part of the implementation of CSR.

Reliable financial reporting is financial reporting that is free from earnings management actions. Earnings management is the use of accounting techniques to produce financial statements that present an overly positive
view of a company’s business activities and financial position to maximize personal gain and ignore other stakeholders’ interests. Based on agency theory, earnings management is carried out because of the information asymmetry between management and stakeholders. This information asymmetry creates agency problems that are detrimental to stakeholders. Therefore, earnings management is often manifested as unethical actions.

The relationship between CSR and earnings management has been studied by accounting academics (Gargouri et al., 2010; Jordaan et al., 2018). However, these studies’ results are still mixed and even contradictory (Moratis & Van Egmond, 2018; Yip et al., 2011). Examination by Ben and Chakroun (2018), and Scholtens and Kang (2013) revealed that CSR disclosure is a determinant of earnings management. According to Liu et al. (2017), firms that carry out CSR are ethical firms that will not carry out unethical actions such as earnings management. Prior et al. (2008) found that earnings management affects CSR disclosure. According to Martinez-Ferrero et al. (2016), firms report CSR to distract stakeholders from management’s earnings management actions.

Previous research findings, which are still inconsistent, mean that the relationship between CSR disclosure and earnings management cannot be concluded (Huynh, 2020). Therefore, this study aims to analyze the relationship between CSR disclosure and earnings management in mining firms in Indonesia. This study is different from previous research because the study aims to investigate the bidirectional relationship between CSR disclosure and earnings management, which to the best of the researcher’s knowledge, has never been studied in Indonesia. Meanwhile, mining firms were chosen as the subject of this study because mining firms’ operational activities are closely related to social and environmental issues. Therefore, this study aims to analyze the two-way relationship between CSR disclosure and earnings management in mining firms listed on the Indonesia Stock Exchange.

2. Literature Review

2.1. Agency Theory

Agency theory refers to the relationship between management and firm owners as an agency relationship. According to Jensen and Meckling (1976), an agency relationship is a relationship in which the principal (firm owner) delegates his authority to the agent (management). In the corporate context, management is in charge of fully managing the company. As a result, management has more information about the firm than the owners themselves. This information asymmetry triggers agency costs in which management acts opportunistically by not presenting reliable information, which maximizes personal gain and harms owners and other stakeholders.

The issue of earnings management and CSR cannot be separated from agency theory, which separates company ownership and control. Management can select and even manipulate the financial information it reports as accountability to stakeholders by performing earnings management. Meanwhile, management can also adjust its CSR disclosure items based on their importance, considering that CSR disclosure is voluntary and full of management discretion (Jordaan et al., 2018; Rao & Tilt, 2016). Based on the agency theory, the relationship between earnings management and CSR can be stated in an opportunistic hypothesis which assumes that companies express CSR well to distract stakeholders from earnings management actions that have been done by the management (Almahrog et al., 2018; Martinez-Ferrero et al., 2016).

2.2. Stakeholder Theory

Stakeholder theory is based on the concept that a company is not an entity that only operates for its interests but must provide benefits to stakeholders. Stakeholders are the firm owners and all parties related to the firm such as employees, customers, suppliers, government, society, and even the environment. Based on the stakeholder theory, the firm should accommodate all stakeholder interests for the sake of business continuity, including providing information about the firm’s activities to all stakeholders.

Stakeholder theory states that firms can reduce agency costs by carrying out social initiatives that affect their relationship with stakeholders, including CSR (Scholtens & Kang, 2013). Firms that focus on CSR disclosure tend to be cited as ethical companies. Based on the stakeholder theory, the relationship between earnings management and CSR is an ethical hypothesis. The ethical hypothesis states that firms that disclose their CSR are less likely to carry out earnings management, which is an unethical act (Kumala & Siregar, 2020).

2.3. Hypotheses Development

CSR is a concept in accounting that emphasizes that firms have economic and legal responsibility and social and moral responsibility to investors, suppliers, customers, employees, government, society, and the environment (Omair Alotaibi & Hussainey, 2016). Based on the triple bottom line concept, CSR is identified into three aspects: economic welfare, environmental quality improvement, and social justice. CSR is the
business world’s commitment to contribute to sustainable economic development by considering economic, social, and environmental issues. Therefore, CSR disclosure is defined as a signal of a firm’s commitment to socially responsible behavior (Gavana et al., 2017).

Earnings management is the act of changing the reported economic performance by management to mislead stakeholders in making economic decisions. Earnings management can be done by using existing accounting standards to obtain predetermined profits or achieve specific goals (Jones, 2011). Accounting is closely related to estimates, judgments, and policies made by management. Also, accrual accounting can be used by management to promote and delay recording transactions. Flexibility in accounting standards creates ambiguity for practitioners in applying specific standards so that earnings management practices can be carried out (Hong & Andersen, 2011).

Firms that report their CSR activities are identified as transparent and accountable companies (Management Association, 2019). Firms that commit to CSR will be responsible for reporting their financial statements (Choi et al., 2013). Firms that have such an ethical attitude will not do earnings management (Ben & Chakroun, 2018; Jones, 1995). This concept is supported by the research findings of Ben and Chakroun (2018), Choi et al. (2013), Hong and Andersen (2011), Li and Thibodeau (2019), and Liu and Lee (2019). They revealed that firms that disclose CSR tend not to do earnings management.

However, other studies have revealed that CSR disclosure is a mask that firms use in covering up their unethical actions, including earnings management (Hemingway & Maclagan, 2004). The firm seeks to divert stakeholders’ attention, especially investors, to the reliability of its financial statements by disclosing CSR. Jordaan et al. (2018), Kim et al. (2012), Martinez-Ferrero et al. (2016), and Patro and Pattanayak (2017) stated that CSR disclosure has a positive effect on earnings management. Therefore, the research hypothesis is formulated as follows:

**H1:** Corporate social responsibility (CSR) disclosure has a significant effect on earnings management.

Earnings management is often perceived as irresponsible and contrary to CSR (Prior et al., 2008). CSR activities are identified as ethical actions. Thus, companies that carry out earnings management are seen as unethical companies and tend not to carry out CSR. However, the research findings of Choi et al. (2018) revealed that companies that carry out earnings management are better at reporting their CSR activities. CSR ratings are negatively correlated with the level of earnings management when all firms are considered. However, the relationship is weaker for firms with highly concentrated ownership, which suggests that CSR practices can be abusively used by those firms to conceal their poor earnings quality. The adverse use of CSR is discouraged if the fraction of shares owned by institutional investors is high. CSR is used to divert the attention of stakeholders from their opportunistic actions towards investors (Almahrog et al., 2015). Prior et al. (2008) investigated the connection between earnings management and CSR. They argued that earnings management practices damage the collective interests of stakeholders; hence, managers who manipulate earnings can deal with stakeholder activism and vigilance by resorting to CSR practices. They found a positive impact on earnings management practices on CSR; this relationship holds for different robustness checks. Also, they demonstrated that the combination of earnings management and CSR has a negative impact on financial performance. By disclosing CSR, the firm seeks public recognition as an ethical and socially responsible company. The firm is convincing other stakeholders to validate its unethical actions, including earnings management. Therefore, the research hypothesis is as follows:

**H2:** Earnings management has a significant effect on corporate social responsibility (CSR) disclosure.

3. Research Methods

3.1. Population and Sample

This research uses secondary data which was obtained from sustainability reports, annual reports, and audited annual financial statements. The data is downloaded through the company’s official website. This study’s target population is all firms engaged in the mining sector listed on the Indonesia Stock Exchange (IDX). The sample selection is made using the purposive sampling method, namely determining the sample by considering specific criteria. Based on this method, the total model of this study is 20 firms.

<table>
<thead>
<tr>
<th>Sample Criteria</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mining firms listed on the stock exchange (population)</td>
<td>47</td>
</tr>
<tr>
<td>Mining firms incurred losses during the period studied (2016–2018)</td>
<td>(25)</td>
</tr>
<tr>
<td>Mining firms did not publish complete data (2016–2018)</td>
<td>(6)</td>
</tr>
<tr>
<td>Total sample</td>
<td>16</td>
</tr>
<tr>
<td>Total observations (2016–2018)</td>
<td>48</td>
</tr>
</tbody>
</table>
3.2. Measuring Variables

The measurement of CSR disclosure in this study uses the content analysis method. Researchers analyzed any content related to CSR topics based on the Global Reporting Initiative G4 standards contained in the annual report and separate CSR (if any) (Hamid & Atan, 2011). Furthermore, the CSR disclosure index is calculated by a weighted non-average index by dividing the actual total score obtained by the total score that should be disclosed by the company (Rosli et al., 2016). In this study, earnings management is proxied by discretionary accruals, which is the accrual rate determined by management policy. The higher the discretionary accrual, the higher the level of earnings management in the financial statements. Discretionary accruals are calculated using a modified Jones model (Dechow et al., 1995). This study involved two control variables, namely firm size and leverage (Saraswati et al., 2020). The firm size is proxied by the natural logarithm of the company’s total sales. Meanwhile, leverage uses the debt to equity ratio.

3.3. Data Analysis Method

The data analysis method used in this study is the multiple linear regression analysis. This study examines a two-way relationship between CSR disclosure and earnings management so that the multiple linear regression equations for this study are as follows.

\[
\text{AbsDA}_i = a + b_1 \times \text{CSRD}_{i,t} + b_2 \times \text{Size}_{i,t} + b_3 \times \text{Lev}_{i,t} + e
\]

\[
\text{CSRD}_i = a + b_1 \times \text{AbsDA}_{i,t} + b_2 \times \text{Size}_{i,t} + b_3 \times \text{Lev}_{i,t} + e
\]

where AbsDA\(_i\) is absolute discretionary accruals (earnings management), \(a\) are constants, \(b_1\) – \(b_3\) are regression coefficients, CSRD\(_i\) is CSR disclosure, Size\(_i\) is firm size, Levi is leverage, and \(e\) are disturbance errors.

4. Results


The analysis of multiple linear regression models with the dependent variable of earnings management shows that the model has met all the classical assumptions, and the model is declared feasible. The simultaneous test result shows that the CSR disclosure, firm size, and leverage simultaneously have a significant effect on earnings management as indicated by a significance value less than 0.05. Table 2 also shows that the coefficient of determination of this model is 0.366, in which 36.6% of the variability of earnings management is explained by CSR disclosure, firm size, and leverage.

Table 2: The Results of the Multiple Regression Linear

<table>
<thead>
<tr>
<th>Model</th>
<th>Standardized Coefficients (Beta)</th>
<th>T</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Constant)</td>
<td>0.255</td>
<td>1.566</td>
<td>0.125</td>
</tr>
<tr>
<td>CSRD</td>
<td>0.434</td>
<td>3.485</td>
<td>0.001***</td>
</tr>
<tr>
<td>Size</td>
<td>−0.233</td>
<td>−1.871</td>
<td>0.068*</td>
</tr>
<tr>
<td>Lev</td>
<td>0.236</td>
<td>1.964</td>
<td>0.056*</td>
</tr>
<tr>
<td>( R = 0.605 )</td>
<td></td>
<td>( R \text{ Square} = 0.366 )</td>
<td>( F = 8.472 )</td>
</tr>
</tbody>
</table>

Note: ***, ** and * indicates significant at 1%, 5% and 10% level of significance based on t-statistics.

Table 3: The Results of the Multiple Regression Linear

<table>
<thead>
<tr>
<th>Model</th>
<th>Standardized Coefficients (Beta)</th>
<th>T</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Constant)</td>
<td>0.709</td>
<td>1.622</td>
<td>0.112</td>
</tr>
<tr>
<td>AbsDA</td>
<td>0.498</td>
<td>3.485</td>
<td>0.001***</td>
</tr>
<tr>
<td>Size</td>
<td>−0.094</td>
<td>−0.680</td>
<td>0.500</td>
</tr>
<tr>
<td>Lev</td>
<td>−0.109</td>
<td>−0.819</td>
<td>0.417</td>
</tr>
<tr>
<td>( R = 0.523 )</td>
<td></td>
<td>( R \text{ Square} = 0.273 )</td>
<td>( F = 5.512 )</td>
</tr>
</tbody>
</table>

Note: ***, ** and * indicates significant at 1%, 5% and 10% level of significance based on t-statistics.
4.2. The Model of the Influence of Earnings Management on Corporate Social Responsibility (CSR) Disclosure

The second model's classic assumption test results show that the model meets the assumptions of normality, heteroscedasticity, multicollinearity, and autocorrelation. Thus, this model is worthy of further interpretation. Table 3 shows that the coefficient of determination of the model is 27.3%, which means that 27.3% of CSR disclosure variability is explained by earnings management, firm size, and leverage. The simultaneous test results show that earnings management, firm size, and leverage simultaneously have a significant effect on the CSR disclosure as indicated by a significance value of less than 0.05. This result also means that the multiple regression analysis model is feasible.

Table 3 above also shows the partial test results. The table shows that the significance value of the earnings management variable is 0.003 below the 0.05 significance rate. This result means that earnings management has a significant effect on CSR disclosure. Meanwhile, the standard coefficient of earnings management variables is 0.498, which means that every one-point increase in the earnings management variable will increase the CSR variable by 0.498. This result also means that the direction of the earnings management’s influence on CSR disclosure is positive. This result is the same as the research result of Huynh (2020), Muttakin et al. (2015), and Prior et al. (2008). Meanwhile, the multiple linear regression analysis results above also show that company size and leverage do not significantly affect CSR disclosure.

5. Discussion and Conclusions

The results of this study reveal that there is a causal relationship between CSR and earnings management. The relationship between the two has a positive direction. These results support the opportunist hypothesis, which reveals that CSR disclosure is a corporate strategy to cover up earnings management actions. Companies that carry out earnings management will try to divert investors’ and other stakeholders’ attention by prioritizing the disclosure of CSR activities (Prior et al., 2008). This action is done to avoid adverse reactions from stakeholders on management’s discretion in preparing financial statements that only maximize management’s benefits (Martínez-Ferrero et al., 2015). The management hopes that by disclosing CSR to stakeholders, management will be seen as having ethical and responsible behavior (Faisal et al., 2020). Management gets support from other stakeholders, primarily social and environmental activists, from the disciplinary action of shareholders whose long-term interests are not fulfilled due to earnings management (Salewski & Zülch, 2012).

Based on the results of multiple linear regression analysis in the first model, CSR disclosure has a positive effect on earnings management. Meanwhile, the results of multiple linear regression analysis in the second model indicate that earnings management impacts CSR disclosure. These results suggest that CSR disclosure and earnings management are two-way relationships or a recursive model (Martínez-Ferrero et al., 2015). This finding is in line with Choi et al. (2018), who revealed the endogeneity problem in the relationship between CSR disclosure and earnings management.

This study reveals that CSR disclosure is part of the management strategy in conducting earnings management. These results verify agency theory that management can exploit information asymmetry in maximizing self-interest. This study also reveals that CSR disclosure and earnings management are two-way relationships. Therefore, there is an opportunity for further research to study this relationship more deeply. Meanwhile, this study results have implications for regulators to increase supervision and control over companies in preparing financial reports and implementing CSR activities. Regulators should formulate a guideline for disclosure of CSR, which is mandatory for all companies so that the form of disclosure of social responsibility among companies is uniform. This study’s findings must be interpreted with caution, considering that the study population includes mining companies listed on the Indonesia Stock Exchange (IDX).

References


