Moderating Effect of Earnings Management on the Relationship Between Corporate Social Responsibility Disclosure and Profitability of Banks in Indonesia

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ABSTRACT

This study aims to obtain empirical evidence of earnings management (EM) as a moderating variable between corporate social responsibility (CSR) and profitability. This research was conducted by taking a sample of banking companies listed in the Indonesia Stock Exchange in 2010-2014. Data were collected using purposive sampling. The statistical method used was moderated regression analysis. Findings proved that CSR disclosure positively and significantly influences a company’s profitability. By contrast, earnings management had a negative and significant influence as the moderating variable on the relationship between CSR and a company’s profitability. These results suggested that a high level of EM, which leads to an enhanced CSR program, corresponds to weak profitability of the banking companies.

Keywords: Corporate Social Responsibility, Earnings Management, Profitability, Banking Sector, Indonesia

JEL Classifications: G2, M14

1. INTRODUCTION

The main objective of a company when it conducts its operational activities is to maximize return to shareholders. Nonetheless, a company is also obliged to contribute to society as a whole. The concept of corporate social responsibility (CSR) and CSR reporting has received much attention, and it has been the focus of many scholars, practitioners, and other international organizations in the last few decades.

Companiees can implement CSR as a significant and real step in contributing to society. Sun et al. (2010) suggested that the public’s attention tends to be recognized as a significant corporate response to communicate CSR and sustainability to the community. The concept of CSR is not new in the banking industry. In the current economic situation, CSR has become the best solution to integrate moral principles in banking activities. Scholtens (2009) suggested that CSR is an increasingly important issue in the banking industry and has seen greater integration in the banks’ business. The number and the type of responsible financial products has increased considerably; an exception is environmental advisory service. As to social conduct, the internal and external social commitment of banks increases substantially.

The phenomenon of CSR in Indonesia is in debate and has not been fully welcomed and executed by business communities. Supriyono et al. (2015) proved that managements in Malaysia and Thailand have a higher awareness of corporate social disclosure (CSD) than managements in Indonesia do. Overall, CSD practices in the three countries are unsatisfactory possibly because the CSD is considered unimportant or a waste of company’s money.

Previous studies have concentrated primarily on the relationship between CSR and profitability. This focus shows that social responsibility of an entity has a positive relationship with a company’s profitability. This concept is in line with some research that says that the disclosure of CSR activities will have a positive influence on the profitability of the current year (Ciciretti et al.,
In their recent study, which used a sample of US companies, Kim et al. (2012) investigated whether socially responsible companies behave differently from other companies in their financial reporting practices. They found that socially responsible firms are likely to engage in aggressive earnings management (EM) through discretionary accruals to manipulate operating activities. This approach has become the subject of the investigation of the Securities and Exchange Commission.

According to Sun et al. (2010), one of the objectives of CSR disclosure is to attract investors to invest in companies. However, the emerging development is that the disclosure appears with regard to the EM conducted by the management. This disclosure is used by managers to distract investors or interested parties from monitoring EM activities. Moreover, Zahra et al. (2005) revealed that the activity of EM may mislead stakeholders with regard to the value of assets, transactions, or the financial position of the company. This approach has negative consequences on the shareholders, the environment in which the company is located, creditors, employees, reputation, and the career security of managers, as well as society as a whole.

Policies that direct the promotion of social responsibility practices do not motivate the desired behavior. CSR might provide managers an additional incentive to utilize CSR for their opportunistic behavior. Thus, policymakers need to be careful about this opportunistic behavior and to increase monitoring to enforce social compliance (Mutakin et al., 2015). The prudence of stakeholders with regard to EM practices can threaten the security of the position of the managers. This prudence may also damage the company’s reputation, thereby providing managers an incentive to compensate stakeholders through practices of social responsibility disclosure in gaining the support of stakeholders (Prior et al., 2008; Cespa and Cestone, 2007; Zahra et al., 2005; Fombrun et al., 2000). The research findings of Chih et al. (2008) also stated that companies with a high commitment to social responsibility perform earnings aggressiveness by deferring the recognition of a loss or accelerating the recognition of income. Although the companies implement social responsibility disclosure, the result will be excessive if EM prevails because of the opportunistic behavior of the management. Thus, financial statements do not reflect the company’s performance accurately, thereby weakening the ability of outsiders to run the company (Leuz et al., 2003).

Furthermore, Prior et al. (2008) reported that the effect of EM and CSR will ultimately have an effect on the company’s financial performance in the long term. Therefore, the company should be able to provide adequate financial resources. The research results of Rahmawati and Dianita (2011) in Indonesia showed that activities related to EM practices negatively affect the company’s financial performance in the future. Another study on the relationship between EM and CSR was conducted by Prior et al. (2008), who found that EM significantly and positively influences a company’s CSR disclosure. This finding means that greater EM by managers corresponds to more extensive CSR disclosure. By contrast, Chih et al. (2008) found a negative relationship between EM and CSR when income smoothing is the indicator of EM. Sun et al. (2010) also showed that no statistically significant association exists between EM and corporate environmental disclosure (CED) as a proxy for CSR.

The research gaps described above indicate that the topic of this study remains an interesting issue to explore, thereby encouraging the researchers to retest EM practices as a moderating variable between CSR and banks’ profitability. This research is interesting because CSR is considered an important form of management accountability to stakeholders. Moreover, companies, especially banking companies, are expected to be sustainable in the future.

2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

2.1. CSR of the Banking Sector in Indonesia

CSR awareness in Indonesia is increasing. Initially, the Company Act No. 1 of 1995 did not include CSR. However, when the Act was revised and enabled in 2007 (the Company Act No. 40 of 2007), CSR began to be included in company strategies (Siregar and Bachtiar, 2010). CSR implementation of government banks was regulated in more detail in the Regulation of the State Minister for State-Owned Enterprises (SOEs) (BUMN) No. PER-20/MBU/2012 on Partnership Program of SOEs with Small Business and Community Development Program (PKBL). PKBL of SOEs was formed specifically to run one of the state’s goals, which is to manage natural resources and state assets for people’s welfare. The CSR of Indonesian private banks is regulated by Law No. 47 Year 2012 on Social and Environmental Responsibility of Limited Company (PT).

2.2. CSR and Profitability

Extensive research has been conducted on the relationship between CSR and profitability. Muñoz et al. (2015) focused on the effects of CSR on companies’ financial performance using the information disclosed by the companies on their website. The final sample consists of 122 companies listed in the Stock Exchange of Madrid (Spain). The effect of CSR practices on companies’ performance is significant. CSR improves financial performance, and, when considering the intangible components of CSR, the relationship is stronger for the company’s long-term performance rather than for short-term performance.

Ciciretti et al. (2014) found significant evidence that banks are better off by adhering to their community-mandated responsibilities. In fact, banks are more likely to be rewarded with lower cost of capital for both debt and equity. In terms of causality,
the paper finds that social and financial performances could be co-determined; however, the relationship between two variables seems to be stronger in the direction of social responsibility having an effect on financial performance. Rajput et al. (2012) showed that company’s expenditures in CSR improve financial performance. Moreover, companies that have more sales and profits spend more on CSR activities.

Furthermore, Chen and Wang (2011) showed that the CSR activities can improve companies’ financial performance in the current year. Aside from that, CSR has a significant effect on companies’ financial performance in the following year, and vice versa. The variations of CSR and financial performance can also significantly influence one another. Inoue and Lee (2011) stated that all proposed dimensions of CSR have a positive financial effect. Their results revealed that each dimension has a different effect on both short-term and future profitability.

Samy et al. (2010) studied the relationship between CSR and financial performance in 20 British companies. They found a weak but positive relationship between the two variables (14.7%). They argued that the company’s CSR policy can affect a company’s bottom line because consumers and investors will become more aware of the law. Therefore, CSR investment is a business expense that is essential to a company’s survival in an increasingly competitive business world. Siregar and Bachtiar (2010) found little evidence of the positive influence of CSR on a company’s future performance. These results could encourage companies to disclose their CSR activities because CSR seems to have a positive influence on future performance.

Moneva et al. (2007) also found a positive relationship between CSR and financial performance. They studied 52 Spanish companies in six different sectors (i.e., gasoline and electricity; basic materials, industry, and construction; consumer goods; consumer services; financial services and real estate; and technology and telecommunications). They measured the level of CSR based on the guidelines of the global reporting initiative (GRI). They found that only 58% of companies reported CSR (sustainability), and 63 percent of them followed the GRI guidelines (Moneva et al., 2007). They stated that the stakeholder-oriented industries obtain higher return than companies that are only shareholder oriented either in total assets or shareholders’ funds (Moneva et al. 2007). Ruf et al. (2001) reported that a positive relationship exists between changes in companies’ social performance with short-term profits (e.g., sales growth) and long-term profits (e.g., return on sales). These arguments lead to the following hypothesis:

Hypothesis 1: CSR positively influences profitability.

2.3. CSR and Profitability with EM as Moderating Variable

The second aspect addressed in this study is the influence of CSR on profitability triggered by EM practices. Through CSR activities, managers have objectives, namely, media reports, the legitimacy of local communities, easing regulations, and receiving the least criticism from investors and workers. At the same time, some activities can reduce the possibility of a boycott of the company’s products and prevent lobbying activities against the company. The essence is that managers believe that by meeting the interests of stakeholders and by creating a positive image and social care and environment, they can reduce the possibility of being investigated by stakeholders with regard to their EM practice (Rahmawati and Dianita, 2011).

Pagano and Volpin (2005) argued that managers will express appreciation to stakeholders, such as employees, in the form of social charity activities as a self-defense mechanism to avoid pressure from the financial markets. Thus, the presumption is that when managers act to pursue personal interests to mislead the stakeholders about the actual value of the company’s assets or financial position, they get a quiet pass from the other stakeholders to validate some practices. Stakeholders can be persuaded to express satisfaction with the company’s policy because of its CSR. By using a sample of 139 companies in 10 Asian countries in 2009, Scholtens and Kang (2013) investigated whether EM relates to CSR. They found that enterprises are likely to be socially responsible to engage in EM. They also found that investor protection is negatively related to EM and that CSR can reduce agency problems between managers and shareholders because it reduces incentives to manage earnings. Hong and Andersen (2011) showed that compared with non-socially responsible companies, socially responsible companies have a higher accrual quality and less activity-based EM, both of which influence the quality of financial reporting. They argued that ethics plays an important role in this relationship. Rahmawati and Dianita (2011) used the CSR activities in Indonesia as a basis to explain that the activities related to EM practices negatively influence a company’s financial performance in the future.

Sun et al. (2010) describes that managers have incentives to disclose environmental information to attract potential investors and enhance their corporate image, especially when they are trying to engage in EM. Agency conflict arises when the managers opportunistically manipulate EM for their own interests. Therefore, CED is a means to secure their jobs, which can also be used to divert the attention of shareholders to the monitoring of EM activities. Managers involved in EM practices seem to be motivated to behave proactively by seeking perceptions from shareholders and other stakeholders that they take action to secure optimal performance. In addition, managers should use financial reports to send relevant information with regard to economic performance of the company to the outside entities if they act in the interest of the company. However, because the audit is not perfect in the real economic world, managers may have incentives to manage earnings opportunistically.

Studies by Prior et al. (2008) found that the CFP is an important control variable when testing the relationship between CSR and EM. Prior et al. (2008) provided a different viewpoint from Chih et al. (2008). They argued that when managers opportunistically act to support themselves in EM, they have more motives to engage in CSR activities. Moreover, they showed that CSR is seen as a defensive device (entrenchment) to garner support from other stakeholder groups whose interests are broken by earnings.
management practices. Therefore, companies are motivated to adopt CSR practices, such as volunteering and performing environmental disclosure. In turn, such practices will affect the CFP. However, they commented that if the companies involved in CSR activities are the consequence of earnings manipulation, then the positive influence of CSR on the CFP will decrease negatively. Hence, our second hypothesis reads as follows:

Hypothesis 2: A higher level of EM corresponds to its stronger negative effect on the relationship between CSR and profitability.

3. METHODS

All data that were used to develop the model of this research are secondary data taken from annual reports of banking companies listed in the Indonesia Stock Exchange (IDX) in 2010-2014. Samples were selected by using purposive sampling with the following criteria: Banking companies are listed in the IDX and consistently publish audited financial statements from 2010–2014; they present CSR disclosure in their annual reports; and their financial statements are accessible over the Internet. On the basis of these criteria, the total sample consists of 15 banking companies (Table 1).

The research model consists of three variables, i.e., dependent variable, moderating variable, and independent variable. The operational definition and measurement of each variable are then described. Companies that have good financial performance capabilities will have high confidence to inform stakeholders, especially investors and creditors, because they are able to demonstrate to them that they can meet their expectations. Financial performance can be measured with use profitability ratios, which are the key measure of overall efficiency and performance. This study uses return on assets (ROA) because they present CSR disclosure in their annual reports; and their financial statements are accessible over the Internet. On the basis of these criteria, the total sample consists of 15 banking companies (Table 1).

The test result of the first model shows that the value of $R^2$ is 17.1%, which means that CSR can explain 17.1% of the variation of profitability; the rest is explained by other factors. The first hypothesis indicates that the CSR variable coefficient is positive (5.606) and significant at the 5% level, thereby showing that CSR has a positive influence on the profitability of the companies; this result is supported empirically. This finding shows that companies that perform CSR activities have increasing profitability. Banks play an important role because they act not only as recipients but also as providers of socially responsible investments. Banks can increase profitability by implementing various policies related to CSR in human resources and community activities.

Before the MRA model was used, classical assumptions were tested. In the multiple linear regression analysis, four assumptions must be met, namely, the assumptions of normality, multicollinearity, heteroscedasticity and autocorrelation. The test results indicate that all assumptions were met. Table 2 presents the results of the statistical tests of the first model related to the first hypothesis tested in this study.

To measure CSR disclosure, this study uses the SR index calculated from the CSR disclosure provided in a company’s annual report (sustainability), whose criteria are classified by the GRI. The data are taken from the annual reports of banks listed in the IDX. This index is calculated by summing all the scores for all CSR items by giving one (1) point if the report is revealed and zero (0) if it is not. The items of CSR disclosure are classified by the GRI. Seventy-nine items of disclosure are classified by the GRI. GRI guidelines selected in this study will be used as the basis for measuring the level of CSR for this guide; these guidelines are the most widely accepted and popular guidelines, and are most widely used by companies (Oeyono et al., 2011; Samy et al., 2010). GRI has been a leading and an internationally recognized standard for CSR reporting.

Hypothesis testing uses a regression interaction or moderated regression analysis (MRA) because MRA can explain the effect of EM in moderating the relationship between CSR and profitability. The research model consists of two (2) equations, namely,

\[
\begin{align*}
\text{PROF}_i &= \alpha_0 + \beta_1 \text{CSRD}_i + \epsilon_i \\
\text{PROF}_i &= \alpha_0 + \beta_1 \text{CSRD}_i + \beta_2 \text{EM}_i + \beta_3 \text{EM}_i \ast \text{CSRD}_i + \epsilon_i
\end{align*}
\]

Where,

- PROF = Profitability
- CSRD = CSR disclosure
- EM = Earnings management
- EM $\ast$ CSRD = Interaction EM and CSR disclosure.

### 4. RESULTS AND DISCUSSION

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These results are consistent with those of Muñoz et al. (2015), Ciciretti et al. (2014), Rajput et al. (2012), Chen and Wang (2011), Inoue and Lee (2011), and Siregar and Bachtiar (2010) who stated that greater CSR activity is corresponds to increased
profitability of the company. This finding means that the companies that report CSRD in their annual reports will convey good news to the public. Banking companies are oriented to gain trust from shareholders and customers. Therefore, they are expected to provide information about social responsibility because doing so will enhance the company’s image. Public trust in the company is clearly a good signal and has a positive effect on the company, thereby increasing profits.

Table 2 shows the value of $R^2$ from the test result of the second regression model. The value is 27.1%, which means that CSR, EM, interaction between EM, and CSRD could explain 27.1% of the company’s profitability; the rest is explained by other factors beyond this study. The analysis of variance result shows that F-statistic is significant at the 5% level, which means that the regression model is suitable for use as the predictive model on company’s profitability. CSR, EM, and interaction between EM and CSRD can also be said to simultaneously influence financial performance of company.

The second hypothesis indicates that the correlation coefficient of EM and CSR (EM*CSRD) is negative (~0.723) and significant at the 5% level. This result shows that empirically, EM and CSR are negatively related to a company’s profitability. Thus, the second hypothesis of this study interprets that a higher level of EM decreases the CSR program and weakens profitability. Thus, EM is proven to weaken the influence of CSR on the profitability of the banking companies. This finding shows the moral hazard behind the management of a company’s CSR programs. These results are consistent with the findings of Rahmawati and Dianita (2011) that CSR activities related to earning management practices influence companies’ financial performance. These results are also in line with Prior et al. (2008), who found that a higher level of EM corresponds to a strong negative effect of CSR on the future financial performance of a company. This negative effect occurs because CSR programs are used by management as a defense strategy to cover EM practices that could damage the interests of stakeholders. Prior et al. (2008) also explained that management has two reasons for performing EM as a way to meet the interests of stakeholders. The first reason is that EM is a precautionary measure that anticipates stakeholders’ attention to the earnings manipulation that could endanger their position in the company. The second reason is that EM is a self-defense strategy that the management uses to align the interests of stakeholders. Cespa and Cestone (2007) explained that the management who manipulates earnings has an incentive to project a socially friendly image through CSR activities to gain support from stakeholders.

5. CONCLUSION

The results of this study indicate that CSRD influences profitability. This finding shows that a better CSRD in the annual report influences the ROA. This result means that CSR disclosure will convey good news to the public, which is expected to provide a good image for the company, thereby enabling it to finally influence the ROA. Considerable funding is needed to produce numerous, varied CSR activities. In conducting CSR activities, a company should plan carefully in allocating the funds, determining activities to be carried out, and designing programs. CSR activities must be implemented seriously and not as a complement. The company must report the conducted CSR activities that aim not only to comply with rules but also to create a good image for the public and the investors. Therefore, maintaining public trust (customers and shareholders) is a must.

CSR activities related to earning management practices influence companies’ profitability. This research indicates that CSR disclosure is performed by companies merely as a defense strategy to cover EM practices that can damage stakeholders’ interests. This approach shows that only a few of the companies that perform CSR activities do so purely out of social responsibility and caring. In banking companies, CSR disclosure is one of the important factors in maintaining the trust of stockholders and customers. The implementation of CSR programs and EM negatively influence companies’ profitability because CSR programs require a large amount of money. Management cannot stay away from the opportunity to perform EM practices when making a financial report, but this must not damage stakeholders’ interest in the long term. Thus, the company will benefit from CSR programs; such benefit includes increased profitability, which will be acquired by the community as well.

Some limitations of this research are the following: (1) The relatively small number of samples, i.e., only 15 banking firms from 40 banking firms listed in IDX in 2014 were used. The limited sample is caused by the limited number of firms that consistently disclosed their CSR activities during 2010-2014, (2) the research sample includes only banking firms; thus, the results cannot be generalized for other sectors, (3) CSR disclosure is voluntarily done by firms, so no standardized regulation exists as a reference...
in measuring the CSR index, thereby resulting in subjectivity in measuring the CSR index. (4) The research instrument measures only the example of the dummy variable, which fails in providing detail information with regard to the quality of the example provided by each firm.

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