# Corporate Social Responsibility Disclosures and Earnings Quality: Evidence from Indonesia

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**Abstract.** This article investigates the impact of corporate social responsibility (CSR) disclosures on earnings quality, as measured by real earnings management (REM). In particular, this study investigates whether CSR reporting are situation-dependent, i.e., if the managements are required to act responsibly to restrain earnings management, hence publish a higher quality of earnings information to shareholders. This study employs 156 listed companies in manufacturing industry in 2018 and 2019 as the sample. Results from the multiple regressions analysis indicate that CSR disclosures has a positive association with earnings quality. The results imply that companies who report more CSR activities in their annual report tend to avoid income-decreasing discretionary accruals activities. This finding suggests that managers who are incentivized to disclose more CSR activities are concerned to reduce information asymmetry which therefore will also be less likely to manipulate earnings. The conclusions of the study have practical consequences for some parties, including regulators, investors, and business associates. From an ethical standpoint, manufacturing firms in Indonesia with more social responsibility provide more reliable financial information.

**Keywords: corporate social responsibility, corporate social responsibility disclosures, earnings management, earnings quality.**

## 1 Introduction

There has been a question regarding whether companies having a greater degree of corporate social responsibility (CSR) reporting tend to produce better or poorer earnings quality. Kim et al. [1] define CSR as an assessment of socially responsible efforts by organizations that provide an advantage to stakeholders as a whole, such as building consumer trust and minimizing pollution. Prior studies have produced contradictory findings. Using worldwide data covering the period from 2001 until 2009, Kim et al. [1] imply that organizations with a greater degree of CSR tend to produce a higher quality of earnings because they avoid manipulation of earnings and provide more reliable financial information. On the contrary, Jensen and Meckling [2] claim that the agent or managers of organizations with a greater degree of CSR strive to pursue self-interest or enhance the company image; as a result, earnings quality tends to decrease, as does financial reporting manipulation.

Certain factors, such as the degree to which executives attempt to prevent manipulation of reported earnings, may influence the association between the extent of CSR reporting and earnings quality, which might explain this apparent contradiction. Choi et al. [3] and Sun et al. [4], for instance, discover that the relationship between the degree of CSR and profits quality weakens as the proportion of institutional investors in a business grows, but the relationship strengthens as the proportion of international investors in a firm increases. In the Chinese context, Zhong and Fan [5] and Rezaee, Dou, and Zhang [6] investigate the relationship between the extent of profit manipulation and the amount of CSR disclosures, finding that enterprises with a higher level of CSR are more transparent and engage in less profit manipulation.

In Indonesia, some studies have examined the relationship between CSR and earnings quality. The results are mixed depending upon the observed sample. In the plantation industry, Muliati et al. [7] find that CSR is more likely to enhance earnings quality. Similar results were also found in companies listed on the LQ 45 index[8]. Aditya and Juniarti [9] investigates the influence of CSR on accrual quality in miscellaneous industry. The study reveals that CSR has no impact on accrual quality. However, similar study observing banking industry in the country, indicates that a higher CSR disclosures are associated with a higher degree of earnings management resulting less quality of earnings [10].

The present study aims to investigate the association between CSR disclosures and earnings quality using the manufacturing industry as the sample. In industries where the production process is highly sensitive to environmental issues, management will have a greater incentive to disclose CSR and convey more business ethics. In line with these ethical issues, the present study expects that companies that participate more in CSR have a better level of ethical conduct in their day-to-day operations, which, therefore, will give their shareholders a higher financial reporting quality, i.e., a higher quality of earnings [3], [11], [12]. The present study also observes firms' size and leverage as the control variables of the determinants of earnings quality.

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## 2 Literature Review

The link between CSR and earnings management is explained by Chih et al. [13] via the myopia avoidance theory. The theory asserts that organizations who engage in CSR have a greater level of ethics in their business operations. In this regard, corporations will furnish shareholders with higher-quality of accounting information. Therefore, managers avoid earnings management since it is seen immoral [14]. Another justification for the myopia avoidance theory is that managers work for both financial and social reasons. Consequently, management will produce a high quality of earnings. The myopia avoidance hypothesis suggests that corporate social responsibility will have a detrimental impact on profits management.

### 2.1 The influence of CSR on earnings quality

Corporate socially responsible management seeks to prevent activities that are detrimental to all stakeholders, including shareholders. In addition, CSR reporting may boost the accessibility of company financial reporting, hence reducing the information asymmetry between agent and principals [15]. Therefore, it is expected that corporate social responsibility can lower the amount of earnings management conducted by management. Previous studies in Indonesia [7], [8], in the US [11], as well as in China [1], [6] demonstrates that CSR positively impact on earnings quality. However in Saudi Arabia, Habbash and Haddad [16] documents that CSR disclosures positively influences earnings management. This study expects the following hypothesis.

**H1**: CSR disclosures is associated with a higher earnings quality.

## 3 Research method

This study uses manufacturing companies listed on the Indonesia Stock Exchange (IDX) in a two-year period starting in 2018 as the sample. The number of companies whose annual reports have been available on the IDX website consecutively in 2018–2019 is 85 out of 143 companies. There are seven companies with outlier data. Therefore, the final sample is 78 companies, resulting in 156 firm-year observations. For the CSR disclosure variable (CSR) measurement, this study follows previous studies [7], [8], [9], [17] which use an unweighted CSR disclosure index as asserted in the Global Reporting Initiatives (GRI). The index has a total of 91 items. The extent of CSR disclosures of the sample company is assessed through the availability of statements in the index as stated in the annual reports or sustainability reporting. The total number of disclosures is counted as a percentage. For the earnings quality measurements, this study employs real activity management (RAM) as suggested by Roychowdhury [18]. Since the present study observes manufacturing firms, for earnings quality measurements the study uses the abnormal level of cash flow from operations (EM_ABCFO). Details of how to calculate EM_ABCFO are available in Rezaee et al. [6],

There are two control variables in the study, namely firm size (Size) and leverage. To calculate Size, this study utilizes the natural logarithm of total assets, while to measure leverage is the division of total debt by total assets. This study employs multivariate regression analysis to examine the influence of CSR on earnings quality.

## 4 Results and Discussion

Table 1 presents the descriptive statistics of all variables tested in the research. Based on the table, the minimum and maximum value of CSR are 0.04 (4 percent) and 0.34 (34 percent) respectively, with the average value of the disclosure being 0.167 (16.7 percent). The level of disclosure is low, especially when compared to the LQ 45 index, which produces 21.3 percent of disclosures. [8]. However the disclosures of manufacturing industry is better than banking which count only 14.57 percent [10]. These numbers suggest that listed enterprises in Indonesia disclose a relatively low level of CSR, according to GRI. The average number EM_ABCFO is 1.3482 with the minimum and maximum values being-0.01 and 19.11 respectively. The number of EM_ABCFO indicates that the lower the number, the lower the earnings management, hence the higher earnings quality. The mean value of Size and leverage is 16.026 and 32.389, respectively.

**Table 1. Descriptive statistics of all variables**

| Variables | Minimum | Maximum | Mean | Std.Deviation |
|---|---|---|---|---|
| EM_ABCFO | -0.01 | 19.11 | 1.3482 | 3.3376 |
| CSR | 0.04 | 0.34 | 0.1673 | 0.0646 |

| | | | | |
|---|---|---|---|---|
| Size | 6.34 | 29.11 | 16.0260 | 4.6162 |
| Leverage | 0.05 | 44.196 | 32.3989 | 35.3868 |

Table 2 displays the results of multivariate regression analysis. As presented in the table, CSR is negatively related to EM_ABCFO, significant at a 5% level. The results suggest that CSR disclosures negatively influence earnings management and hence increase earnings quality. The findings support the expectation that companies with better ethical practices, as reflected in CSR disclosures, produce higher reporting quality, as reflected in earnings quality. Our findings are in line with previous studies in China. [1], [6] and in the US [11].

In terms of control variables, leverage is also negatively associated with EM_ABCFO, significant at a 5% level. It indicates companies with a higher number of debt have a tendency to avoid earnings management, which in turn reports a better quality of earnings. Our finding is consistent with Rezaee et al.[6] indicating that companies who ow more will receive more attention from creditors, hence giving more incentives to the management to produce more reliable information.

**Table 2. Multivariate regression analysis**

| | B | t | Sig | Tolerance | VIF |
|---|---|---|---|---|---|
| Constant | 0.479 | 1.137 | 0.257 | | |
| CSR | -0.179 | -2.057 | 0.041* | 0.987 | 1.013 |
| Size | -0.131 | -0.964 | 0.337 | 0.972 | 1.028 |
| Leverage | -0.039 | -2.483 | 0.014* | 0.985 | 1.015 |
| F Value | | | 4.251 | | |
| F Sig | | | 0.006** | | |
| Adjusted $R^2$ | | | 0.059 | | |
| Kolmogorov Smirnov Sig | | | 0.104 | | |

*= shows significant at 5% level, ** = shows significant at 1% level

## 5 Conclusion

The present study aims to investigate the influence of CSR disclosures on earnings quality, as measured by REM. Results from the multiple regression analysis indicate that CSR disclosures have a positive association with earnings quality. The results imply that companies that report more CSR activities in their annual report have fewer income-decreasing discretionary accruals. The finding suggests that to lessen information asymmetry, managers who are encouraged to disclose more about their CSR practices will also be less motivated to manipulate earnings. The conclusions of the study have practical consequences for some parties, including regulators, investors, and business associates. From an ethical standpoint, manufacturing firms in Indonesia with more social responsibility provide more reliable financial information.

This study has limitations that may be overcome by future research. The adjusted $R^2$ is low, which counts only 5.9 percent. Therefore, future research may add independent variables in the regression model such as corporate governance and ownership structure.

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