

## EFFECT OF CORPORATE GOVERNANCE ON RELATIONSHIP BETWEEN CORPORATE SOCIAL RESPONSIBILITY AND FIRM SIZES WITH EARNINGS MANAGEMENT

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### ABSTRACT

This study aims to empirically examine the influence of corporate social responsibility and firm size on earnings management, as well as how corporate governance influences the relationship between corporate social responsibility and firm size with earning management. The concept of earning management in this study adopted a model developed by Beneish (1999). Beneish implementation of M-Score Model will be modified and adjusted for firms in Indonesia. Beneish M-Score Model is developed to differentiate between manipulator and non-manipulator firms, using financial report element based on 8 ratio index. Agency theory (Jensen dan Meckling, 1976) implies the existence of information asymmetry. Information asymmetry arises when managers are more aware of internal information compared to the stakeholders. Gargouri et al. (2010) shows a positive relationship between corporate social responsibility with earning management, caused by expensive environmental activities. The results of Chih et al. (2008) study shows that companies with a high commitment to corporate social responsibility tend to do earning management. Based on positive accounting theory (Watts dan Zimmerman, 1986), earning management occurs because of political cost motives. Political costs include all costs that must be borne by the company related to government regulations, one of which is the tax burden. Large companies in a tax avoidance effort tend to reduce their profits. Lee and Choi (2002) states that firm size has a negative effect on earning management. In the other hand Rahmani and Mir (2013) states that firm size has a positive effect on earning management.

The population in this study is based on manufacturing companies listed on the Indonesia Stock Exchange for the period 2013-2017, using a purposive sampling method with a specified criteria. The analysis technique uses statistical descriptive and Moderated Regression Analysis (MRA).

**Keywords:** corporate social responsibility, firm size, earnings management

### 1. INTRODUCTION

Large firms with complex organization structure will also cause a high degree of accounting complexity. This condition has the potential to create agency conflicts and cause information asymmetry. Information asymmetry between management and the owners give managers the opportunity to conduct earning management. Earning management is a manager's decision to choose certain

accounting policies that are considered to be able to achieve the desired goals, to increase profits or to reduce the level of losses reported (Scott, 2015: 445). Earning management as a deliberate process within the limits of generally accepted accounting principles that led to the expected level of profit (Schipper, 1989).

Based on Positive Accounting Theory (Watts and Zimmerman, 1986), one of the causes that led to earning management is *political cost* motive. *Political cost hypothesis* states that companies tend to choose and use accounting methods that can reduce or increase reported earnings. *Political cost hypothesis* is related to government regulations, one of which is the tax burden. In order to increase the value of the firm's stock, management is motivated to provide the best information about the company performance. Therefore, the management will attempt to reduce the tax which is an element of profit reduction to optimize the firm profits. Likewise, large firm in a tax avoidance effort will tend to reduce their profits. Firm size can be determined based on the amount of labor, market capitalization, total sales, and total assets. In this study total assets are used as a proxy for the firm size, because total assets are relatively more stable than any other measurement form (Sudarmadji dan Sularto, 2007). Lee and Choi (2002) state that firm size has a negative effect on earning management. However, Rahmani and Mir (2013) found that firm size has a positive effect on earning management.

Another cause of earning management being conducted by firms is the motive of Corporate Social Responsibility (CSR). This is consistent with the result of the study by Chih et al. (2008) which states that firms that are highly committed to CSR often delay their recognition of losses, or accelerate their recognition of profits. CSR rests on *triple bottom lines* principle (Barnea dan Rubin, 2006: 56), which is corporate responsibility on social, environmental, and economical aspects. Fontaine (2013) states that CSR objectives include the accountability of firm activities and optimizing the positive influence of the firm through activities related to the environment, consumers, labor, community, stakeholders and other interested parties.

Study on the influence of CSR on earning management has been carried out by previous researchers with mixed results. There is a significant positive relationship between CSR and earning management (Gargouri et al., 2010), and a negative relationship between CSR and earning management (Izadinia et al., 2014; Scholtens dan Kang, 2012; Yip et al., 2011), and no significant relationship between CSR and earning management (Grecco et al., 2015; Rahmawati dan Dianita, 2011). To achieve the objectives of CSR activities in improving the company's long-term performance, it is necessary to integrate the role of corporate governance with CSR implementation strategy. The concept of corporate governance is intended to achieve more transparent corporate management process.

Good corporate governance can reduce agency conflicts and increase disclosure that can limit information asymmetry. Corporate governance is a system that regulates and controls companies that are expected to provide and increase the value of the company to stakeholders (Brown dan Caylor, 2006).

Weak corporate governance is considered to play an important role in the large firms bankruptcy and crises in various countries (Reddy et al., 2010; Ross dan Crossan, 2012; Ujunwa, 2012). Jun-Koo (1995) stated that poor corporate governance was one of the causes that led to an economic crisis in East Asia in 1997-1998, including Indonesia. At the end of 2015, Otoritas Jasa Keuangan announce that from 10 ASEAN countries that already implement corporate governance, Indonesia still lags behind Malaysia, Singapore, and Thailand.

Based on the background above, the formulation of the problem in this study is how the effect of corporate social responsibility and firm size on earning management, as well as how the effect of corporate governance on the relationship between corporate social responsibility and firm size with earning management.

## 2. LITERATURE REVIEW

### 2.1 Agency Theory and Earnings Management

Scott (2015:445) defines earnings management as the manager's decision to choose an accounting policy based on a certain standard with the aim of maximizing the welfare and / or market value of the firm. This behavior encourages managers to conduct an earning management. The main reason why managers conduct earning management is to create prosperity for the owner or shareholders of the company. This is in line with the *agency theory* which emphasizes that the authority received by managers from the firm owners to manage and run a firm has logical consequences that must be carried out by managers and company owners.

Positive accounting theory put forward by Watts and Zimmerman (1986) attempts to explain why accounting policies are a problem for firms and parties with an interest in financial statements, and to predict accounting policies chosen by firms under certain conditions. Positive accounting theory uses agency theory to explain and predict the choice of accounting policies taken by managers. There are three motivations that can explain why a manager conduct earning management efforts, which is capital market motivation, contractual motivation (incentive) or managerial and debt compensation, and government regulation.

Beneish (1997) argues that there are substantial measurement errors in accrual estimates managed by the company, due to the depreciation expense not included in the total accruals. Similar findings are also found in the research of Young (1999) and Stubben (2010). Beneish then developed a model that can be used to detect earning management by using a financial statement proxy with the Beneish *M-Score Model*. Beneish *M-Score Model* is further developed in the study conducted by Beneish, Lee and Nicols (2013). This model has been proven to be able to accurately detect 76% of public company registered in the United States (Beneish, 1999) and 71% of the most prominent financial reporting scandals before the public announcement were made by relying solely on accounting data disclosed in the annual report. Detection of earning management implementation has been previously discussed with various models. One of the score

manipulation models that has been reliably tested in various studies is the Beneish *M-Score Model*.

## 2.2. Corporate Governance

Corporate governance is a system that regulates and controls companies that are expected to provide and increase the value of the company to shareholders (Brown and Caylor, 2006). Earning management practices carried out by management can be minimized through a monitoring mechanism, designed to align the interest between owners and the management. Mechanism that can be used to limit such actions is the mechanism of good corporate governance. The purpose of corporate governance is to create added value for stakeholders. Effective governance is expected to improve company performance (Eiteman et al., 2010: 8).

The success of the implementation of corporate governance is largely determined by the quality of supervision carried out by the board of commissioners (Ross dan Crossan, 2012). The board of commissioners is designed to monitor conflict of interest in an effort to ensure ownership and control components that will ultimately contribute to the maximization of the company value (Ehikioya, 2009). Independent commissioners function is to align the interests of shareholders in order to protect the rights of minority shareholders. Regulation from Otoritas Jasa Keuangan Number 55/POJK.04/2015 concerning board of directors and board of commissioners, that in order to achieve a good corporate governance, the proportion of independent commissioners must be at least 30% of the total number of members of the board of commissioners.

Corporate governance is expected to overcome agency problems, by giving confidence to shareholders, that managers will benefit investors and will not invest in unprofitable projects, and relate to how shareholders can control managers in charge (Shleifer dan Vishny, 1997; Atmaja, 2008: 13). The survey conducted by Mc. Kinsey (2002) shows that corporate governance is the main concern of investors. Investors tend to avoid firms that have bad corporate governance.

In this study, the corporate governance aspects that will be used are the proportion of independent commissioners, because the independence nature of the board of commissioners is needed to maintain the integrity to ensure that supervision and advisory function can be carried out correctly. The participation of independent commissioners is designed to improve the firm's ability to protect itself from environmental threats while at the same time aligning company resources to gain greater profits (Ehikioya, 2009).

## 2.3. Corporate Social Responsibility

According to the *World Business Council for Sustainable Development* (WBCSD, 2000), corporate social responsibility (CSR) is a business commitment to contribute to sustainable economic development, through collaboration with employees and companies representatives, local communities and the general public to improve

quality of life in a way that is beneficial, for both the survival and development of the company's business. For organizations, CSR is a mechanism for integrating environmental and social attention into operations and interactions with stakeholders (Darwin, 2008:37). According to UU Number 40 of 2007 concerning Perseroan Terbatas (limited liability company), in article 1 paragraph (3) states that corporate social responsibility is the firm's commitment to participate in sustainable economic development in order to improve the quality of life and the environment that is beneficial for the firms, communities, and society in general. In its development, The research finding from Chih et al. (2008) stated that firms with high commitment to corporate social responsibility conduct earning management by delaying their recognition of losses or accelerating their recognition of profits.

Theory that supports the disclosure of Corporate Social Responsibility (CSR) is agency theory. Jensen and Meckling (1976) states that the agency relationship is a contract between *the agent* and *the principal*. The occurrence of a conflict of interest between the owner and management can be caused when management is acting not in accordance with the interests of the owner, and thus triggering the agency cost. Corporate governance relates to how investors control their managers (Shleifer dan Vishny, 1997). In other words, corporate governance is expected to suppress or reduce the *agency costs*.

## 2.4. Firm Size

Firm size is a measurement on how big a firm is based on the value of equity, sales value, or asset value. One indicator of the size of a firm is the total assets of the firm (Lee, 2009). Firm size is a proxy of financial strength as a scale to classify how big or small a firm is. One of the benchmark to show the size of the firm is by using the total assets of the firm (Dashmash, 2015; Isbanah, 2015; Lee, 2009; Nilres dan Velnampy, 2014). Firm that has a large total assets shows that it has already reached a maturity stage. At this stage the firm's cash flow is already positive and considered to have a good prospects in a relatively long period of time, in addition it reflects that the firm is relatively stable and able to generate profits compared to firms with low amount of total assets.

The size of the firm is also related to earning quality, because the larger the size of the firm the business continuity will be higher in improving the financial performance, so firms does not need to practice profit manipulation. A high quality firm can be said if the profit presented in the financial statements is the actual profit that describe the actual financial performance of the firm. Lee and Choi (2002) found that firm size has a negative effect on earning management. Large firms tend to have a lack of motivation to practice earning management, because shareholders and outside parties are considered to be more critical than small firms. However, Rahmani and Mir (2013) found that firm size have a positive effect on earning management, because large-sized firms must be able to meet high expectations from shareholders or investors.

## 2.5. Previous Study and Hypothesis Development

The study results from Gargouri et al. (2010), shows that the dimensions of *corporate social performance* on environment and employees are positively related to earning management. This relationship can be explained by the fact that managers are involved in earning management because of expensive environmental activities. From the perspective of *stakeholders*, Earning management tends to be considered a contrary to CSR activities that emphasize in good relations with stakeholders. With regard to the reduction of research and development costs due to earning management, the firm will lose the right opportunity and time to develop and produce an innovative product. Firm with a high level of CSR activities have incentives to limit earning management to achieve a good image and good brand reputation, by creating a good relationships with stakeholders. Based on the explanation above, the hypothesis developed in this study is as follows:

H<sub>1</sub>: Corporate Social Responsibility affects earnings management

Firm size can be measured using total assets, sales, or capital. One indicator that shows the size of the firm is the total assets of the firm (Dashmash, 2015; Isbanah, 2015; Lee, 2009; Nilres dan Velnampy, 2014). Firm size is related to earning quality. The larger the size of the firm, the higher the business continuity of the firm to improve their financial performance, so that the firm itself does not need to conduct earning manipulation practices. A firm is said to be quality if the profit presented in the financial statements is the actual profit and describes the actual financial performance of the firm. Lee and Choi (2002) found that firm size has a negative effect on earning management. Large firms tend to have a lack of motivation to practice earning management, because shareholders and outside parties are considered to be more critical than small firms. However, Rahmani and Mir (2013) found that firm size has a positive effect on earning management, because large-sized firm must be able to meet high expectations from shareholders or investors. Based on the explanation above, the hypothesis developed in this study is as follows:

H<sub>2</sub>: Firm size affects earning management

Based on previous study, the combined effect of CSR and good governance on earning management will be stronger compared to the individual effects of governance on earning management. A good governance will strengthen the relationship between CSR and earning management. Good corporate governance is very helpful and important to limit earning management (Dechow, Sloan, dan Sweeney 1996; Klein 2002; Sarkar, Sarkar, dan Sen 2008; Prawitt, Smith, dan Wood 2009). Although most studies support the notion that corporate governance helps reduce earning management, the results of previous study are still diverse. Based on the explanation above, the hypothesis developed in this study is as follows:

H<sub>3</sub>: Corporate governance strengthens the relationship between corporate social responsibility and earning management.

Lee and Choi (2002) found that firm size is a variable that can influence a company's tendency to manage its earnings. Smaller firms use earning management to avoid losses compared to larger firms. The results of Shu and Chiang (2013) study on the effect of firm size on earning management for large firms shows that earning management has a positive effect on *short term wealth* and has a negative effect on *long term wealth*. To avoid information asymmetry inside a firm, a firm needs a good corporate governance. With good governance, a company will be more transparent, accountable, responsible, independent and reasonable so that it will affect the practice of earning management in the firm itself. Based on the explanation above, the hypothesis developed in this study is as follows:

H<sub>4</sub>: Corporate governance strengthens the relationship between firm size and earning management.

### 3. RESEARCH METHODS

The study population uses manufacturing companies listed on the Indonesia Stock Exchange in the period 2013-2017, using purposive sampling method with a specified criteria.

#### 3.1. Research Variables and Measurement

a. Corporate Social Responsibility (TSP)

Corporate social responsibility is measured based on the amount of social responsibility costs that have been realized by the company.

b. Company Size (UKP)

Company size is measured based on total assets, because the amount of assets is relatively stable compared to other measurement.

c. Corporate Governance (TKP)

The indicator of corporate governance in this study uses the proportion of the number of independent board of commissioners compared to the number of commissioners.

d. Earning Management (MLB)

Earning Management measurement uses *Beneish M-Score* earnings manipulation index. According to Beneish (1999), there are 8 ratios used in the *Beneish Ratio Index* as follows:

1) Days' Sales in Receivables Index (DSRI)

$$DSRI = \frac{Receivables_t \div Sales_t}{Receivables_{t-1} \div Sales_{t-1}}$$

2) Gross Margin Index (GMI)

$$GMI = \frac{(Sales_{t-1} - COGS_{t-1}) \div Sales_{t-1}}{(Sales_t - COGS_t) \div Sales_t}$$

3) Assets Quality Index (AQI)

$$AQI = \frac{1 - (Current Assets_t + PPE_t) \div Total Assets_t}{1 - (Current Assets_{t-1} + PPE_{t-1}) \div Total Assets_{t-1}}$$

4) Sales Growth Index (SGI)

$$SGI = \frac{Sales_t}{Sales_{t-1}}$$

5) Depreciation Index (DEPI)

$$DEPI = \frac{\frac{Depreciation_{t-1}}{Depreciation_{t-1} + PPE_{t-1}}}{\frac{Depreciation_t}{Depreciation_t + PPE_t}}$$

6) Sales, General and Administrative Expenses Index (SGAI)

$$SGAI = \frac{SGA Expense_t \div Sales_t}{SGA Expense_{t-1} \div Sales_{t-1}}$$

7) Leverage Index (LVGI)

$$LVGI = \frac{\frac{Long Term Debt_t + Current Liabilities_t}{Total Assets_t}}{\frac{Long Term Debt_{t-1} + Current Liabilities_{t-1}}{Total Assets_{t-1}}}$$

8) TATA (Total Accruals to Total Assets)

$$TATA = \frac{Income before extraordinary item_t - Operating Cash Flow_t}{Total Assets_t}$$

### 3.2. Data Analysis Method

Data analysis in this study use descriptive statistics to describe the variables studied. Earning management is calculated with 8 *Beneish Ratio Index* by using financial data from manufacturing firms listed as sample, which then an M-Score equation will be obtained. M-Score equation is the eighth mathematical model composition of index numbers for manufacturing firms listed as public firms in Indonesia. To determine the cut-off value that will be used to differentiate and classify between manipulator or non-manipulator firms, this study will use a discriminant analysis method. This study use moderation variables of corporate governance as the main part, where the hypothesis will be analyzed using *Moderated Regression Analysis* (MRA). According to Gozali (2007) MRA is a multiple linear regression application where within it there is an element of interaction. MRA will be carried out with the help of SPSS version 23 software.

### 3.3. Hypothesis Testing

Hypothesis testing is carried out to determine the effect of corporate governance on the relationship between corporate social responsibility and firm size with earning management. Structure that describes the causality relationship between each variables is shown in Figure 1.

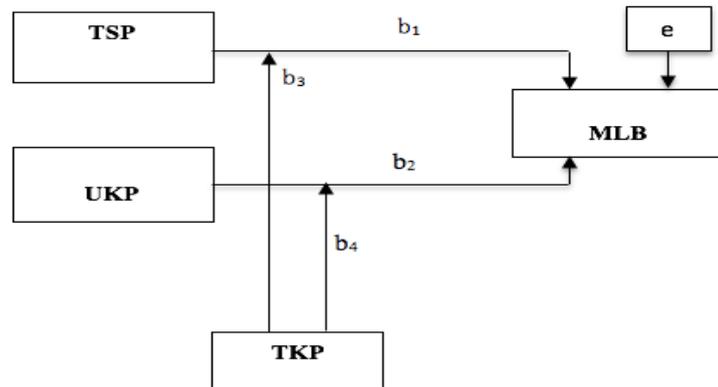


Figure 1

**The Effect of Corporate Governance on Relationships Between Corporate Social Responsibility and Firm Size with Earning Management**

1) Hypothesis Testing 1

$$MLB = \alpha + b_1 TSP + e \dots\dots\dots (1)$$

If the significance level is  $\leq 0,05$  the company's social responsibility affects earning management, and if the significance level is  $> 0,05$  the company's social responsibility does not affect earning management.

2) Hypothesis Testing 2

$$MLB = \alpha + b_2 UKP + e \dots\dots\dots (2)$$

If the significance level is  $\leq 0,05$  the size of the firm affects earning management, and if the significance level is  $> 0,05$  the size of the firm does not affect earning management.

3) Hypothesis Testing 3

$$MLB = \alpha + b_1 TSP + b_4 TKP + b_5 TSP.TKP + e \dots\dots\dots (3)$$

Regression output from equations (1) and (3) can be seen by looking at the coefficient of determination, or  $R^2$ . If there is a positive increase between  $R^2$  values in the first and third equations, this means that corporate governance is a variable that strengthens the relationship between corporate social responsibility and earning management.

4) Hypothesis Testing 4

$$MLB = \alpha + b_2 UKP + b_4 TKP + b_6 UKP.TKP + e \dots\dots\dots (4)$$

Regression output from equations (2) and (4) can be seen by looking at the coefficient of determination, or  $R^2$ . If there is a positive increase between  $R^2$  values in the second and fourth equations, this means that corporate governance is a variable that strengthens the relationship between firm size and earning management.

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