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# EARNINGS MANAGEMENT AND ITS RELATIONS WITH CORPORATE SOCIAL RESPONSIBILITY

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**Yousf Almahrog[1], Awidat Marai[1], Goranka Knežević[2]**

[1]Al-Gabel El-Gharbi University, Faculty of accounting, Libya
[2]Singidunum University, Faculty of Business in Belgrade, Serbia

**Abstract**. *The ethics of financial reporting assumes a center stage in the corporate world in the background of an emerging understanding of corporate social responsibility (CSR). We review the literature on the link between earnings management (EM) and CSR and reveal that there are two contradictory perspectives. One perspective assumes that EM is negatively associated to CSR, while the other argues that EM and CSR are positively related. These perspectives are based on the competitive existence theories such as agency, singling, stakeholder, legitimacy theories. While, the negative relationship between EM and CSR perspective is in line with the legitimacy, agency and singling theories, the positive relationship is in accordance with stakeholder theory.*

**Key words**: *earnings management, corporate social responsibility, stakeholder theory, legitimacy theory, agency theory*

## INTRODUCTION

Accounting earnings are one of the most commonly used measures of firm performance. Given that the flexibility of accounting standards provides the executive managers of a firm with considerable opportunities for practicing discretion over reported earnings, it is not surprising that executives manipulate earnings when the interests between them and stakeholders are conflicted. This opportunistic behavior is known in the literature as Earnings Management (EM). It has been acknowledged that the practice of EM may reduce the financial reports' reliability and quality, their usefulness for investment decisions and the shareholders' confidence in financial statements. In addition, EM has a negative impact on a firm such as, losing stakeholders' support, legal actions could be taken by regulators against the firm, the firm's products and services may be boycotted, it is likely to be deemed as illegitimate by the local community and it could be exposed by the media.

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**Corresponding author**: Goranka Knežević
Singidunum University, Danijelova 32, Belgrade, Сербиа
E-mail: gknezevic@singidunum.ac.rs

Ultimately, these actions by outsiders may damage the firm's reputation, and could result in the managers losing their jobs.

On the other hand, in the last few decades, the corporate world has been predisposed by the growing awareness on Corporate Social Responsibility (CSR) and become more conscientious on how they generate and expend profits. Currently, firms are more concerned about their ethical and moral behavior, and their relationship with relevant societal interest groups. It has been accepted that firms can gain multiple advantages through building a positive image among the stakeholders, and in establishing social bonds with employees and the local community, which generates reputational gains. In practice, those companies who implement CSR activities are bound to provide transparent and reliable financial information. Some authors demonstrate a commitment to ethical and accountable behavior. However, there is an argument that CSR can be used as an entrenchment mechanism to achieve managers 'self-interest objectives by distorting earnings information.

Hence, the aim of this paper is to review the literature on the link between EM and CSR. The remainder of this paper is organized as follows. Section 1 provides EM background. Section 2 presents background on CSR. Section 3 reviews the literature and relevant theoretical perspectives on CSR and EM. In the last section conclusion is presented.

## 1. EM BACKGROUND

Accounting earnings are one of the most significant components in the financial reporting to provide information about a company's performance to various stakeholder groups who are interested in the company's activates, such as investors, the government, professional institutions, lenders and employees. Since these various stakeholder groups would not have the authority to access this information compared to firm's insiders, financial reporting is considered as the main resource used by investors to make investment decisions. The revelations of massive accounting scandals involving large corporations (e.g. Enron, WorldCom, etc.) indicate that managers have incentives to use their discretion over reported earnings either to mislead shareholders about the firm's underlying financial performance or to gain some private benefits at the expense of other stakeholders (Healy and Wahlen, 1999). The flexibility of the Generally Accepted Accounting Principles (GAAP) allows managers to use some discretion to estimate reported earnings that might be not accurately reflect the company's underlying economic conditions (Prior et al., 2008). This opportunist behavior of using managers' discretion is known as earnings management (EM).

EM is the process of taking deliberate steps within the constraints of GAAP to bring about a desired level of reported earnings (Davidson et al. 1987). Similarly, Schipper (1989, p.92) states that EM is "a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gains". In addition, Parfet (2000) illustrates that EM is not entirely a bad thing if reasonable and proper practices of EM are used in a well-managed business and deliver value to shareholders. In the same vein, Beneish (2001) indicates that opportunistic and informative are two perspectives of EM. While opportunistic EM seeks either to mislead investors or to secure managers' jobs, reputations, and compensation within the firm, the informative EM aims to provide private information to the investors about the firm's future performance. In order to determine whether EM is opportunistic behavior or informative exercise, it is important to identify managers' intent. Hence, many attempts have been made in the literature to identify various motivations to manage earnings. However, in some case the opportunistic earnings managing leads to financial fraud, for more see (Marai and Pavlović, 2013).

According to Healy and Wahlen (1999, p. 370), there are three major incentives to manage earnings: capital market, contractual arrangements and regulatory considerations. With regard to capital market, previous capital market literature indicates that issuing equities and beating or meeting analysis' forecasts may motivate managers to manipulate earnings (Chen et al., 2010; Hafzalla, 2009; Payne and Robb, 2000; Healy and Wahlen, 1999). In terms of contractual arrangements, managers have incentives to manipulate reported earnings to influence borrowing and compensation contracts in order to avoid the violation of debt covenants (DeFond and Jiambalvo, 1994) or to gain better bonus rewards (Healy, 1985). As a result of the external pressure from authorities on the firm regarding product prices and market share, mangers may prefer to manage earnings to give the impression that their firms are less profitable than they actually are (Prior et al., 2008). In addition to these motivations, Prior et al. (2008) state that achieving mangers' private gains is one of the main reasons why mangers manipulate reported earnings.

It is worth mentioning that there are two common types of EM: real and accrual-based EM. In terms of real EM, managers can manipulate earnings via modifying corporate transactions, such as reducing expenditures on research and development, advertising, employee training to increase earnings (Guillamon-Saorin and Osma, 2010). Although this type of EM is less likely to be detected by auditors and regulators, it is generally believed to be a more costly form of EM (Hong and Andersen, 2011). On the other hand, accrual-based EM occurs when managers used their judgment to estimate firm's accruals portion without making any changes to real corporate activity such as estimating provisions for dubious accounts and deferring tax assets (Guidry et al., 1999; McNichols and Wilson, 1988). Because this type of manipulation is accounting based, it is generally believed to be a less costly form of EM compared to real EM, and thereby, preferred by managers (Beneish, 2001).

It has been argued that EM is more likely to reduce the financial reports' reliability and quality, their usefulness for investment decisions and the shareholders' confidence in the financial statements (Chen et al., 2010). In addition, Fombrun et al. (2000a) argue that EM has a negative impact on a firm such as losing stakeholders' support, legal actions could be taken by regulators against the firm, the firm's products and services may be boycotted, it is likely to be deemed as illegitimate by the local community and it could be exposed by the media. Such actions by outsiders may damage the firm's reputation, and could result in the managers losing their jobs (Prior et al., 2008). In order to avoid or mitigate opportunistic EM negative consequences, managers have incentives to compensate stakeholders through engaging in Corporate Social Responsibility (CSR) activities.

## 2. CSR BACKGROUND

According to the classical viewpoint, a firm is only accountable to its shareholders and therefore its role in society is to maximize its economic value, which in turn increases the wealth of its shareholders. Hence, managers' responsibility is to act in the interest of the firm's shareholders and they have no right to engage in social projects that do not maximize the returns of the business (Friedman, 1962). In general, the classical viewpoint assumes that the only social responsibility of a business entity is to use its resources to engage in activities that increase its profits without resorting to deception or fraud (Friedman, 1962, p.112). However, in the last few decades, the role of corporation has changed as a result of CSR developments. Thus, corporations are now not only accountable for generating profits for shareholders but also have responsibilities in terms of how they generate these profits. Thus, firms have been forced to become more concerned about their ethical and moral behavior as well as their relationship with societal interest groups and their social responsibility (Held, 1970).

Given that CSR is related to complex issues such as environmental protection, human resources management, health and safety at work, local community relations, and relationships with suppliers and customers, engagement in such activities might be costly for firms (Branco and Rodrigues, 2006). However, several incentives have been reported in the literature to motivate CSR implementation in general and motivate companies to implement natural environmental management in particular. For example, Branco and Rodrigues (2006) and Orlitzky et al. (2003) argue that CSR activities assist firms to enhance their transparency and build a positive image among stakeholders, which in turn helps them to gain support from the society in which they operate. According to Fombrun et al. (2000b), a positive image helps managers to establish social bonds between the company, its employees and the local community, and generates reputational gains that improve the firm's ability to attract resources, enhance its performance, and build a competitive advantage. In addition, Fombrun et al. (2000b, p.85) describe five complementary motivations that induce firms to engage in and pursue CSR activities: (1) Build community ties and maintain a license to operate; (2) Increase morale and attachment of current employees; (3) Prepare and attract potential employees; (4) Develop potential customers; and (5) Enact an environment where the company can prosper. Furthermore, Branco and Rodrigues (2006) demonstrate that, by engaging in social activities, firms can gain support from their various stakeholders and obtain more favorable regulatory treatments, endorsements from activist groups, legitimacy from the community, and favorable coverage from the media. Therefore, these activities may help firms to avoid the potentially detrimental impact of government actions. Thus, engaging in corporate social responsibility may have positive impacts on the firm's reputation within society and may enhance the position of the managers within the firm, particularly when they practice their duties in accordance with the principles of CSR.

Despite the advantages of engaging in CSR, it has been argued that managers might have incentives to use CSR activities as a strategic tool to compensate stakeholders influence how they perceive the real future of the firm, distracting attention from any activities that reduces financial reporting quality (Hemingway and Maclagan, 2004). In addition, DeMaCarty (2009) argues that skillful managers may be able to profit personally through measuring CSR, and that this could be the reason for the positive relationship between CSR and financial performance reported in previous studies. As a result, CSR may be adopted by firms in order to create an impression of transparency among the stakeholder groups and then legitimize their activities in order to gain stakeholders support (Kim et al., 2012). From this viewpoint, engaging in CSR activities is driven from opportunistic behavior rather than moral obligations.

## 3. EM AND CSR PERSPECTIVES

The separation between ownership and control in modern corporations, together with the presence of information asymmetries within companies, spawn the possibility of opportunistic behavior by managers from those of the owners, and hence pursue self-interning objectives (the agency problem) (Prior et al., 2008). Given that managers practice EM either to gain some private benefits at the expense of other stakeholders or to mislead shareholders about the firm's underlying financial performance (Healy and Wahlen, 1999), it has been acknowledge that EM is considered as a type of agency cost because managers look after their own interests by releasing financial reporting that do not reflect an accurate economic picture of the company (Prior et al., 2008). On the other hand, corporate reported information is viewed as a form of monitoring mechanism used by investors and other external users to reduce the information asymmetry problem (Huang and Zhang, 2011). Hence, information disclosed in financial reporting is considered as one of the possible solutions to reduce the agency problem between managers and shareholders (Eng and Mak, 2003).

Theoretically, EM and CSR are linked through two perspectives. First, it has been argued that firms with strong commitments to CSR are less likely to manage earnings since they do not hide unfavorable earnings realizations and, therefore, conduct no EM (Chih et al., 2008). Since EM is perceived as an irresponsible act with CSR principles, Choi et al. (2013) argue that firms with strong commitment to CSR are more prone to act in a responsible way when reporting their financial statements. Likewise, Kim et al. (2012) point out that companies that expend their efforts and resources in designing CSR programs and implement these programs to address the ethical interests of stakeholders follow more transparent and reliable financial reporting and less likely to manage earnings.

Inversely, the second perspective suggests that managers who manage earnings may strategically use CSR information to disguise their opportunistic behavior (Prior et al., 2008). According to Prior et al. (2008), managers who engage in EM may resort to CSR to deal with their stakeholders' activism and vigilance (Prior et al., 2008). In line with this argument, Choi et al. (2013) argue that managers who act in pursuit of private benefits by distorting earnings information are able to entrench themselves through engaging in CSR activities.

Empirically, the studies of Choi et al. (2013); Kim et al. (2012); and Chih et al. (2008) found that EM is negatively related to CSR suggesting that firms with strong commitment to CSR are less likely to engage in EM. On the other hand, several studies have found that EM and CSR are positively related (Gargouri et al., 2010; Prior et al., 2008; Patten and Trompeter, 2003) and suggesting that firms with a higher level of EM resort to CSR activities to disguise managerial opportunistic behavior.

The stakeholder theory offers a beneficial foundation for research into the connection between EM and CSR. According to the stakeholder theory, CSR is seen as obligatory for the firm to discharge wider accountability norms by providing information to relevant stakeholders (Buhr, 2001; Guay et al., 1996). The stakeholder theory is about groups and individuals who can affect or be affected by the organization, and how the organizations manage those groups and individuals (Freeman, 1984). The theory further views that organizations have a duty and obligation to a wider range of stakeholders (Buhr, 2001; Guay et al., 1996) and the managers decisions need to incorporate the interests of all stakeholders (Grougiou et al., 2014). However, this perspective provides a prescription for how managers can undertake strategies to manage and treat their various stakeholders; it does not have a direct role in predicting managerial behavior in practice (Deegan, 2002). Since the firm is perceived as a multilateral set of relationships amongst stakeholders, Grougiou et al. (2014) indicate that since mangers attempt to attend a multilateral set of stakeholders objectives, the information asymmetry between mangers and stakeholder is high. The existence of information asymmetry provides managers an opportunity to practice EM. Further to this, Hoque (2006) argues that managers manipulate earnings to improve their private interests at the expense of other stakeholders. Moreover, Grougiou et al. (2014); and Sun et al. (2010) illustrate that companies that engage in CSR to negotiate diverse stakeholders interests are inadvertently expected to practice EM. Thus one can assume a positive relationship between EM and CSR in the stakeholder theory framework.

Since the engagement with CSR is one of the management strategies to endorse firm's legitimacy (Grougiou et al., 2014), we looked into the views of the legitimacy theory on our central issue. The legitimacy theory is perceived as a generalized perception that the actions of any entity are desirable within some socially constructed system of norms, values, beliefs and definitions (Suchman, 1995, p.574), argues that an organization activities must be legitimate in the eyes of society if it is to be allowed to continue its operations. Hence, if a company loses its legitimacy, society may revoke its contract and prevent it from continuing its operations (Deegan and Rankin, 1996; Guthrie and Parker, 1989). Various strategies that firms can adopt in order to maintain their legitimacy within the society in which they operate, and all these strategies can be involved to make social disclosure as a means of showing that firms are conforming to society's expectations (Dowling and Pfeffer, 1975). Although a firm may choose CSR to maintain or increase perceptions of its legitimacy (Patten, 1992), it may use this as a means of anticipating or avoiding social pressure as well as enhancing the firm's image or reputational status (Gray et al., 1988). In terms of EM, Sun et al. (2010) indicate that managers who manipulate earnings tend to realize that CSR can be used to maintain the firm's legitimacy, specifically with social and political stakeholders. Thus the CSR is seen as a means of informing stakeholders on the wider interests of the firm and of its accountability which prompts the firm to behave in a socially responsible manner.

It is also possible that managers would be involved in activities that could indirectly harm the company and stakeholders except managers. The separation of ownership and management of a company, together with existence conflicts problem and information asymmetry, could create serious problems because mangers are more concerned about their job security, rewards, ability to remain in power, and to maximize their own wealth (Morris, 1987). Agency problems occur and conflicts arise between managers and owners when the managers act for their own benefits rather than optimizing the firms' value from the stakeholders' viewpoint (Watts and Zimmerman, 1986). Information asymmetry occurs when managers have superior access to the information as compared to the owners (Fields et al., 2001). While managers work in the firm every day and are knowledgeable about all business transactions and affairs, stakeholders, on the other hand, depend on periodic sources of information, such as annual and interim reports to enable them to valuate firm's value. Thus, information asymmetry will be higher if the quality of information is low. Managers could undertake opportunistic EM to achieve their objectives, which in turn, increasing firm's agency cost. Since agency relationships suffer from the problems of conflict of interest and information asymmetry, an optimal solution should be discovered to control such problems. Several solutions have been introduced in the literature to solve firm's agency problems. For example, Watts and Zimmerman (1986) argue that the transparency and accountability system is one of the solutions that should be put in place in order to avoid agency problems. Jo and Kim (2007) argue that EM occurs less in companies that disclose more information on their social activities, because when the information transparency is increased, it is expected that the information asymmetry between managers and investors will decrease, which will enable investors to detect EM. Likewise, Eisenhardt (1989, p.60) states that "….since information systems inform the principal about what the agent is actually doing, they are likely to curb agent opportunism because the agent will realize that he or she cannot deceive the principal". Similarly, Shleifer (2004) argues that manipulation of earnings occurs less often in corporations with a strong commitment to CSR. In addition, Chih et al. (2008) state that a strong commitment to CSR principles prevents managers from using their opportunistic discretion over earnings.

Finally, in terms of the signaling theory, Gray (2007) illustrates that firms with high-quality information tend to use CSR as an alternative to the classical financial reporting, while low-quality information companies choose non-disclosure, consistent with constrained accounting information. In addition, Gray argues that the quality of company reports is a signal to investors and financial markets that managers are able to control social risks within the company. Likewise, Sun et al. (2010) indicate that corporate environment disclosure as a part of CSR is a signal to investors and other powerful and economic stakeholders that the company is actively taking part in CSR and that its market value is in good condition. According to the signaling theory, a company discloses information to reduce information asymmetry and to signal to investors that it is performing better than its competitors (Álvarez et al., 2008; Miller, 2002). However, Hughes (1986) states that the credibility of information provided by a firm is an essential element in ensuring lower information asymmetry. Given that EM is more likely to occur when information asymmetry is high, the signaling theory assumes that CSR information is used as a means to reduce the information symmetry (agency problem) between companies and their investors. Therefore, based on the notion that CSR information is a useful tool for reducing information asymmetry, prior studies predicted a negative association between CSR information and information asymmetry (Heflin et al., 2005; Brown et al., 2004; Coller and Yohn, 1997; Welker, 1995), which indicates a negative relationship between EM and CSR.

## CONCLUSION

The aim of this paper is to review the link between EM and CSR. This review reveals that EM and CSR are linked through two contradictory perspectives. Since EM is perceived as an irresponsible act and inconsistent with CSR principles, the first perspective argues that firms with strong commitment to CSR are more prone to act in a responsible way when reporting their financial statements. On the other hand, the second perspective argues that CSR can be used as an effective tool in dealing with stakeholder activism and vigilance when managers manipulate earnings.

In line with these perspectives, it can be concluded that the empirical previous studies have found mixed and contradictory results. While several studies find that EM and CSR are negatively related, others find that EM and CSR are positively related.

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# UPRAVLJANJE DOBITKOM I NJEGOVA VEZA SA KORPORATIVNOM DRUŠTVENOM ODGOVORNOŠĆU

*U korporativnom svetu danas, etika finansijskog izveštavanja podrazumeva i razumevanje koncepta korporativne društvene odgovornosti. Istražili smo dostupnu literaturu pokušavajući da uspostavimo vezu između upravljanja dobitkom i korporativne društvene odgovornosti i kao rezultat došli smo do zaključka da su to dve potpuno različite perspektive. Jedna podrazumeva da je upravljanje dobitkom negativno korelirano sa korporativnom društvenom odgovornošću, dok druga dokazuje da su pozitivno korelisane. Ove perspektive su zasnovane na teorijama kao što su agencijska, teorija signala, teorija stejkholdera i teorija legitimnosti. Negativna veza između upravljanja dobitkom i korporativne društvene odgovornosti je u skladu sa teorijom legitimnosti, agencijskom i teorijom signala, dok je pozitivna veza u skladu sa postulatima teorije stejkholdera.*

Ključne reči*: upravljanje dobitkom, korporativna društvena odgovornost, teorija stejkholdera, teorija legitimnosti, agencijska teorija*