CHAPTER II

THEORITICAL BACKGROUND AND HYPOTHESIS DEVELOPMENT

2.1 Stakeholder Theory

Freeman (1984) defined stakeholder as a person or a group of person who can influence or is influenced by the achievements of an organization's targets. Stakeholders consist of stockholders, creditors, managers, employees, customers, suppliers, local communities, and the general public (Hill & Jones, 1992). Stakeholder theory proposed that an organization have a responsibility and obligation to not only maximising profit for owners, but also should consider how their operation affect stakeholders and an organization (Rankin, 2018).

Stakeholder theory is emphasizing on the accountability of the corporation exceed the financial performance. Stakeholder theory also stated that the companies will have more tendency to disclose more information, including its social, environment, and intellectual performance exceed its mandatory in order to fulfill the expectation of the stakeholders. Stakeholder theory also discussed about normative or ethical branch and managerial branch. According to the ethical branch, it is explained that organizations should fairly treat all of their stakeholders and all of the organization's activities should benefit all of its stakeholders. Additionally, the managerial branch explained that the presence of stakeholders might influence organizational actions.

Stakeholder theory assumes that the existence of the company needs support from its stakeholders. Cho and Chun (2015) stated that companies would have a

strong intention to maintain good relationship with all of its stakeholders. The disclosures of social and environment then can be seen as a form of communication between companies and stakeholders (Rokhlinasari, 2015). Therefore, the companies will tend to disclose and provide relevant and reliable information in order to maintain a good relationship with its stakeholders because the existence of the companies depend on its stakeholders.

2.2 Signalling Theory

Signalling theory is theory that also known as the theory of disclosure regulation, where the entities who issue financial reporting, could increase their value (Rankin, 2018). Signalling theory emphasizes that information disclosed influences consumer decision-making processes. Signalling theory roots from pragmatic accounting theory which focuses on the effect of information in changing the behavior of reporting users (Rokhlinasari, 2015). One of the information component that can be used as a signal is the disclosure that is disclosed by the entities. The disclosure of accounting information can give a signal whether the entities has good prospects or bad prospects in the future.

Therefore, signalling theory would propose that a company who discloses more information would reduce the condition of information asymmetry and it would provide a signal to stakeholders that company is performing better than its competitors (Álvarez et al. 2008). CSR is one of the signal that will potray the quality of the management (Rokhlinasari, 2015). When the company has a good performance, the company will disclose these information publicly as the signal

towards stakeholders that the company would have a good prospects in the future. When the companies disclose more relevant and reliable information about the companies' performance to give the 'signal', the stakeholders will treat these information as a useful information to make economic decision. Therefore, if the company disclose and engage more in CSR, it can be indicated as a signal that the companies have good performances and it is indicated that the companies are not engaging with unethical behavior such as earnings management.

2.3 Agency Theory

Agency theory is a theory that explained the relationships between a person or group of persons employs the services of another in order to perform some activity on their behalf. In other words, this theory explains the relationship between the principal and agent which called as agency relationship (Astari et al. 2020). In the agency relationship, the principal will delegates the decision-making authority to the agent. With the assumption that both parties are utility maximizers, it means the agent will not always follow the interests of principal, therefore there is a conflicting interests.

Since the agents or the managers are dealing with the day-to-day activities of the company, the agents will have more knowledge and information about the company compared to the principals or shareholders. The condition of information asymmetry between the agents and principals gives the agents opportunity to engage with unethical behavior such as earnings management. However, the presence of corporate governance, such as institutional ownership will have higher

supervision and control on the management (Nurleni et al., 2017). Therefore institutional ownership is expected would be able to constraint the unethical activity such as earnings management (Ajay & Madhumathi, 2015). Moreover, Nurleni et. al. (2017) found that companies with higher institutional ownerhsip will provide higher CSR disclosure.

2.4 Corporate Social Responsibility

2.4.1 Definition and Characteristics of CSR

Corporate Social Responsibility (CSR) includes information about the company philanthropy, environment, employees, and other information related to the community (Cahyaningtyas et al 2015). ISO 26000 defined CSR as the form of responsibility for the impact resulted from the companies' acitivities towards the society and environment which shown that companies are committed to operate socially responsible and ethically. CSR is related to morals and ethics (Firmansyah et. al. 2020). The concept of CSR is intended to potray that the companies always try to maximize the positive impacts of its operation towards all of its stakeholders in the term of economics, social, and environment.

According to Elkington (1998) in Astari (2012), the concept of CSR can be described in the model of triple bottom line; they are people, planet, and profit. The concept of triple bottom line explained that the companies should not only seeking for economic profit, but its operation should also consider about the social function and environmental maintenance.

a. People

The companies have to put their attention on the human welfare. The examples in the implementation of CSR are providing scholarship, establishment of educational and health facilities, training and health program provided for employees.

b. Planet

The companies should pay attention on its environment and the sustainability of biodiversity. The examples in the implementation of CSR are the provision of clean water, having a proper waste management system, and using the energy efficiently.

c. Profit

The companies has the orientation to seek for economic return in order to keep operating and surviving in the market.

2.4.2 The Implementation of CSR

The implementation of CSR in Indonesia is regulated in several regulations. First, UU No 40 of 2007 about Limited Liability Companies, it regulated the obligations for companies in dealing with natural resources to carry out social and environmental responsibilities. In the same year, it was published UU No 25 of 2007 concerning capital investment. It was explained that every companies who are engaged in capital investment, should implement corporate social responsibility. In 2012, it was published

PP No 47 of 2012 about Social and Environmental Responsibility of Limited Liability Companies, which regulates the mechanism of implementing corporate social and environmental responsibility.

In August 2012, BAPEPAM-LK issued regulation of BAPEPAM-LK No. KEP-431/BL/2012 about the annual report disclosure by listed company (Tamba, 2015). Based on that regulation point 2.a.1.g, the annual report of a company should contain corporate social responsibility. Moreover, in point 2.h.1, BAPEPAM-LK stated that companies should disclose policies, the types of program, and cost incurred of its CSR activities.

2.4.3 Benefits and Objectives of CSR Disclosure

The disclosure of corporate social responsibility is one of the way done by the companies in order to provide information and communicate the social environment information towards stakeholders. The disclosure of corporate social responsibility is very useful for stakeholders because the stakeholders would notice and understand the performance of the company and therefore the stakeholders can make a useful decisions. Companies who provide more information, including CSR, will attract more investors and it will be resulted with a good image of the company. With this good image, the company would be able to attract more investors and can maintain its sustainability in the market.

The implementation of CSR is not only beneficial for the company itself. The programs of CSR held by the company are very useful in building and maintaining the sustainability of its social and environment. The program of CSR would be beneficial for the improvement of the economic in society, providing some training programs, providing development of skills and health program to its employees, and moreover the companies would be able to save energies such as use less paper.

2.5 Earnings Management

2.5.1 Definition of Earnings Management

Earnings or bottom line or net income is a measurement of companies' performance which are important for the financial statement users in indicating whether the company has engaged in activities that increase the company's value (Rankin, 2018). According to Healy and Wahlen in Rankin (2018), earnings management is occured when the managers use their judgment to change the reported financial information and to deceive the stakeholders perspectives about the truly economic performance of the company (Rankin, 2018). Meanwhile, McKee in Rankin (2018) identified that earnings management as reasonable and legal decision made by the management in order to report stable and predictable financial results.

The varied definition of earnings management is categorized by Ronen and Yaari in Rankin (2018) as white, grey, or black. White earnings

management will enhance the transparency of financial reports. Grey earnings management is a choice of accounting method that is either opportunistic or would be economically efficient. Black earnings management involves misrepresentation, reducing transparency or even fraudulent scheme. Therefore, the concept of earnings management could be ranged from a beneficial mechanism; that is signals long-term companies' value to the stakeholders; harmful earnings management where the companies will conceal the actual performance, or neutral if the companies provide the true performance of its activities (Rankin, 2018).

2.5.2 The Motivations of Earnings Management

According to Rankin (2018), there are two motivations of earnings management.

a. Earnings management that is conducted by the management to benefit the companies: such as meet the analysts' and shareholder expectation and predictions, maximize the share price and the value of the company, and to avoid the companies' failure or distress.

b. Earnings management that is conducted by the management in order to maximizing the managerial bonuses.

Additionally, (Scott, 2015) also stated some motivations of earnings management:

a. Bonus Purpose

Since the managers have the information about the companies' performance, the managers could engage in opportunistic activity that is manage the earnings in order to achieve the bonuses or the managerial compensation based on the agreement.

b. Political Motivations

Earnings management activity is conducted by the management in order to decrease the earnings reported by the public companies. The companies tend to decrease the earnings reported in order to avoid the pressure from the public that is avoid the complicated regulations from the government.

c. Taxation Motivations

One of the motivation of earnings management is to reduce the amount of tax payed by the company.

d. Change in CEO

The research found that when there is changes in CEO, there could be a practice of earnings management. The previous CEO will use earnings management to conceal his poor performance in order to get more bonuses before his leaving. In the other hand, the next CEO will utilize earnings management to blame the poor performance of previous CEO by using big bath, therefore they could increase earnings in the following year.

e. Initial Public Offering (IPO)

When a company decided to going public, the financial information disclosed in the prospectus is considered as an essential information. These information will give signal towards the stakeholders regarding the value of the company. The management will likely engage in earnings management in order to influence the investors' decision making.

2.5.3 Technique of Earnings Management

According to Rankin (2018), the methods of earnings management that are widely used are: accounting policy choice, the use of accruals, income smoothing, real activity management, and big bath.

a. Accounting Policy Choice

The flexibility of the accounting choices in accounting standard requirements creates an opportunity for earnings management. The example of accounting policy choice are whether the management use straight-line or accelerated in calculating depreciation expense, FIFO or weighted average for inventory valuation, and etc.

b. Accruals Accounting

Managers are prefer to generate revenue that consistent with the earnings growth. The shareholders would prefer to invest in the company who had consistent earnings growth. Therefore, the

managers have a tendency to use the accruals accounting to manage the revenue from time to time. Accruals accounting is an accounting method where the revenue will be realized when the transaction is taking place, not when the cash is received. Accruals accounting can be classified as discretionary accrual and non-discretionary accrual.

c. Income Smoothing

Income smoothing is an attempt to moderate the earnings fluctuations in order to achieve a stable reported earnings. The stability of the earnings can be achieved by income minimization or income maximization.

d. Real Activity Management

Real earnings management is achieved through the operational activities of companies during the fiscal year. The examples of real activity management are accelerating sales, price discounts, reduce discretionary expense, and etc. According to Rankin (2018), real activities of earnings managment is less likely to catch the attention from the auditors compared with the accruals earnings management because the auditors tend not to question actual pricing and production decisions.

e. Big Bath

The technique of 'big bath' is conducted by managing the earnings throughout the year so the earnings would become higher or lower

compared with the earnings in the previous period or the following period. The big bath accounting is often use when there is a change of management team, such as CEO.

2.5.4 Model of Earnings Management

Earnings management can be calculated using two models, they are Accrual Earnings Management and Real Earnings Management.

2.5.4.1 Accrual Earnings Management

Accrual earnings management is earnings management that is carried out using accounting policies (Darmawan et. al., 2019). Accruals accounting can be classified as discretionary accrual and non-discretionary accrual. Accruals that could not be controlled by the management is called as non-discretionary accruals (Xiong, 2006). Accruals that are resulted from the flexibility of the management to decide the accounting policy used is called as discretionary accruals. Therefore, discretionary accruals are assumed to be the result of manager's opportunism (Darmawan et. al., 2019).

Strakova (2020), stated the examples of accrual-based earnings management techniques are: recording sales before they are realizable; recording fictitious sales; the methods of amortization, depreciation, and depletion; and understatement of provisions for bad debts. The prior research found that management are more likely

to engage in accrual-based earnings management because accrual-based earnings management is less costly to use (Khaled, 2018). There are some models that have been developed by researchers in determining accrual accounting, one of the models that are commonly used is The Modified Jones Model.

2.5.4.2 Real Earnings Management

Real earnings management is another action that is used by the managers to achieve the intended profit target. Real earnings management departures from normal operational practices (Roychowdhury, 2006). Real earnings management is considered more advantegous compared to accrual earnings management because it is considered not easily discovered by regulators or auditors (Darmawan et. al., 2019). According to Roychowdhury (2006), the methods of real manipulation are:

a. Sales Manipulation

Sales manipulation is defined as an attempt by the management in order to increase the number of sales by offering price discounts or providing more lenient credit terms. The offer of price discounts would accelerate the number of sales and it will be resulted with the increase of earnings. The other way to increase the number of sales temporarily is by offering more lenient credit terms. The example is

when the retailers and automobile manufacturers offered lower interest rates near the end of their fiscal years.

b. Overproduction

In order to increase earnings, the management of manufacturing companies could produce more goods excessing the necessary numbers. The increase of production numbers would decrease the number of Cost of Goods Sold (COGS) because the fixed overhead cost will be divided by the larger number of units, resulted with the reduction of fixed cost per unit.

c. Reduction of Discretionary Expenses

Discretionary expenses consist of research and development expense, advertising expense, sales expense, general & administratives expenses, and maintenance that expensed in the same period. The company implement the earnings management by decreasing the discretionary expenses, therefore it would be resulted with higher earnings.

2.6 Institutional Ownership

Institutional ownership can be defined as an ownership which are held by institutions companies: foundations, banks, insurance companies, investment companies, pension funds, limited liability companies (PT) and other institutions (Nurleni et. al., 2017). One of the methods to reduce the agency conflict is by increasing the number of institutional ownership in order to monitor the managers

(Jensen & Meckling, 1976). The presence of institutional owners is considered able to optimize the monitoring of management's activities and decision making. Institutional ownership is considered having more risk because most of them owned a large number of shares compared with individual shareholders. This condition encourage them to supervise managers more actively and restrictively (Wati & Malik, 2021). It would be resulted that the managers would take better accounting and financial decisions.

Most of Indonesian companies are stockholders in the form of business institutions (Wardhana & Tandelilin, 2011). Therefore, institutional ownership is used in this research in order to investigate whether the ownership is able to moderate the model. Since the institutional owners may encourage managers to take better accounting and financial decisions by monitoring the managers more restrictively, it is expected that the presence of institutional investors would be able to constraints the opportunitic behavior of management such as earnings management. Moreover, the institutional investors would urge the managements to disclose more information, including CSR in order to obtain a relevant and reliable information about the company. Therefore, higher institutional ownership is considered able to moderate the relationship between CSR and earnings management.

2.7 Previous Research

Table 2.1: Summary of the Previous Research

No	Researcher	Title	Variables	Findings
1	Kim, Park, Wier (2011)	Is Earnings Quality Associated with Corporate Social Responsibility?	Independent: Corporate Social Responsibility Dependent: Earnings Quality, measured by DAC and REM	The research found that CSR negatively impact earnings management for both accruals and real. Indicating that company who is actively implementing CSR will have less intention to manage earnings either using DAC or REM.
2	Cho and Chun (2015)	Corporate Social Responsibility, Real Activities Earnings Management, and Corporate Governance: Evidence from Korea	Independent: Corporate Social Responsibility Moderating: Corporate governance Dependent: Real Earnings Management.	The research found that CSR negatively affect REM. Corporate governance as moderating variable strengthen the negative relationship between CSR and REM.
3	Sembiring (2017)	Earnings Management and Corporate Social Responsibility Disclosure with Board Independence	Independent: Corporate Social Responsibility Moderating: Board Independence,	CSR negatively impact earnings management using discretionary accruals. Additionally, board independence and

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		and Institutional Ownership as Moderating Variable.	Institutional Ownership Dependent: Earnings Management	institutional ownership are able to strengthen the negative relationship between CSR and EM.
4	Khaled (2018)	The Relationship between CSR Disclosure Quality and Accrual and Real Earnings Management: Large-Scale Evidence from India.	Independent: Quality of Corporate Social Responsibility Disclosure (QCSRD) Dependent: Real Earnings Management (REM) and Accruals Earnings Management (AEM).	The research found that QCSRD is negatively and significantly associated with both AEM and REM
5	Kinasih et. al. (2018)	The Relationship between Corporate Social Responsibility and Earnings Management : Agency Theory Perspective.	Independent: Corporate Social Responsibility Dependent: Earnings Management	It is found that CSR has no impact on earnings management. The control variables: leverage and size also has no impact on earnings management. Meanwhile, the control variable ROA has positive significant effect on earnings management.

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6	Buertey et. al. (2019)	Corporate Social Responsibility and Earnings Management: The Moderating Effect of Corporate Governance Mechanisms.	Independent: Corporate Social Responsibility Moderating: Corporate governance (board size, board independence, institutional ownership, and block ownership) Dependent: Earnings Management	There is a significant positive impact of CSR on EM using discretionary accruals. The board size and block ownership significantly moderates the CSR–EM relationship. Meanwhile, board independence and institutional investors do not have a significant moderating effect on the CSR–EM relationship.
7	Ruwanti et. al. (2019)	Corporate Social Responsibility and Earnings Management: The Role of Corporate Governance.	Independent: Corporate Social Responsibility Moderating: Corporate governance Dependent: Earnings Management	There is a positive impact of CSR on EM. The corporate governance has a significant negative effect on CSR - earnings management relationship.
8	Wiyadi et. al. (2019)	Corporate Social Responsibility Disclosure, Ownership Structure and Earnings Management: Empirical Studies	Independent: Corporate Social Responsibility, Ownership Structure (Family Ownership Structure, Foreign Ownership	It is found that foreign ownership structure, concentrated ownership and institutional ownership has no significant effect

		in The Real Estate Companies Listed in Indonesian Stock Exchange.	Structure, Concentrated Ownership Structure, Institutional Ownership Structure Dependent: Earnings Management	on earnings management. While corporate social responsibility disclosure and family ownership structure has significant effect on earnings management.
9	Abhirama and Ghozali (2021)	The Impact of Corporate Social Responsibility towards Earnings Quality with Ownership Structure as Moderating Variable.	Independent: Corporate Social Responsibility Moderating: Ownership structure (managerial ownership, institutional ownership) Dependent: Earnings Quality (measured by discretionary accruals)	Corporate social responsibility has a positive effect on discretionary accruals earnings management. The managerial ownership has no significant effect on CSR and earnings quality relationship. Meanwhile, institutional ownership has a significant effect on CSR and earnings quality relationship.
10	Kurniawati (2021)	The Impact of Corporate Social Responsibility towards Real Earnings Management with Corporate Governance	Independent: Corporate Social Responsibility Moderating: Corporate Governance (managerial	There is a negative relationship between CSR and Real Earnings Management (REM). It means, the greater disclosure of CSR,

		Mechanism as Moderating Variable.	ownership and institutional ownership) Dependent: Real Earnings Management	the smaller real earnings management. Managerial ownership cannot strengthen the relationship between CSR and real earnings management. The institutional ownership can strengthen the relationship between CSR disclosure and real earnings management.
11	Wati and Malik (2021)	Corporate Social Responsibility and Earnings Management: The Moderating Role of Corporate Governance	Independent: Corporate Social Responsibility Moderating: Corporate governance (board size, board independent, institutional ownership, block ownership Dependent: Earnings Management	There is no significant effect between CSR and EM. The corporate governance could not moderate the relationship between CSR and EM. The results have an indication that CSR activities do not have any impact on EM with Corporate Governance as moderating variable

2.8 Hypotheses Development

2.8.1 The Impact of Corporate Social Responsibility on Earnings Management.

CSR is a commitment of entities to act ethically, operate legally, and contribute to increase the prosperity of its employees, local community, and community as broad (Sankat, 2004 in Isyanto, 2014). The disclosure of CSR would reduce the information asymmetry between management and the stakeholders. This statement is in line with signalling theory where this theory assumed that CSR reporting is considered as a signal to mitigate the information asymmetry between management and stakeholder (Khaled, 2018). The condition of information asymmetry create a possibility for management to engage with earnings management. Therefore, if the company disclose and engage more in CSR, it can be indicated as a signal that the companies has good performances and it is indicated that the companies are not engaging with unethical behavior such as earnings management.

Moreover, according to stakeholder theory, the companies will disclose more information about companies' activities in order to provide information to its stakeholders as the form of responsibility. The existence of the companies depends on its stakeholders, and in order to maintain the relationship, company will provide more transparent, relevant and reliable information towards its stakeholders. Therefore, the more companies

provide CSR disclosure, the more the transparency provided, and thus it can be indicated that companies are not engaging with unethical activity, that is earnings management. This statement is in line with the previous research that have been done by Cho and Chun (2015), Sembiring (2017), and Khaled (2018) which found that the more the CSR disclosure, the less the practice of earnings mangement or there is a negative relationship. Based on the argument the first hypothesis can be formulated as follows:

H1a: The corporate social responsibility negatively impact on accruals earnings management.

H1b: The corporate social responsibility negatively impact on real earnings management.

2.8.2 The Impact of Institutional Ownership as Moderating Variable on the Relationship between Corporate Social Responsibility and Earnings Management.

The agency conflict between the agent and principals due to the condition of information asymmetry can be reduced with the presence of institutional ownership. The presence of institutional owners is considered able to optimize the monitoring of management's activities and decision making. As institutional investors own majority of stocks, the institutional investors would have stronger intention to monitor the management more actively and restrictively compared with other stockholders (Nurleni et. al.,

2017). They may encourage managers to take better accounting and financial decisions.

Thus, the institutional owners would encourage management to disclose more information, including CSR and could constraint the management to do unethical activity. Therefore, it is expected that the presence of institutional investors would be able to constraints the opportunistic behavior of management such as earnings management. The previous research from Nurleni et. al (2017) found that companies with higher institutional ownership will provide higher disclosure of CSR. Moreover, the research from (Ajay & Madhumathi, 2015) found that companies with higher institutional ownership are found to have higher earnings quality which means it has lower earnings management activity. Thus it is expected that the institutional ownership is able to strengthen the negative relationship between CSR and earnings management. Based on the argument, the second hypothesis can be formulated as follows:

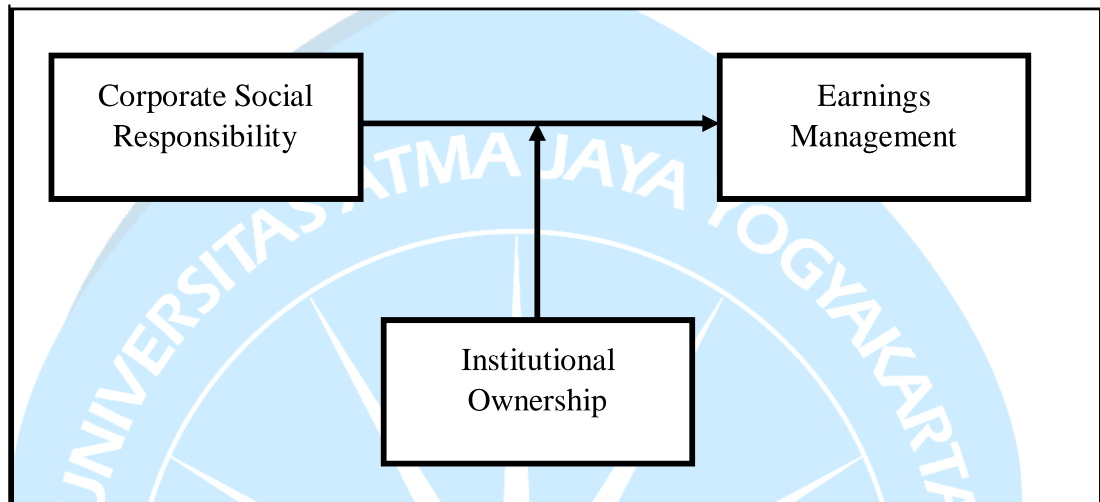
H2a : Institutional ownership strengthen the negative effect of the relationship between corporate social responsibility and accruals earnings management.

H2b : Institutional ownership strengthen the negative effect of the relationship between corporate social responsibility and real earnings management.

2.9 Research Model

The research model of this study could be depicted as follow:

Figure 2. 1: Research Model



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