CHAPTER II

THEORETICAL BACKGROUND AND HYPOTHESIS DEVELOPMENT

2.1 Stakeholder Theory

The survival of the company depends on the support of stakeholders. Social disclosure is considered as part of a dialogue between the company and stakeholders (Gray et al., 1995). The company is not the only entity operates for his own benefit, and to gain support from stakeholders companies must provide benefits to its stakeholders. Edward Freeman (2001) on his article said that Stakeholders are those groups who have a stake in or claim on the firm. Lawrence et al., (2005), stakeholders are all the groups affected by, or that can affect, an organization's decisions, policies, and operations. Stakeholder theory argues that corporations serve a broader public purpose: to create value for society.

Companies should maintain a relationship with its stakeholders to accommodate the desires and needs of its stakeholders, especially stakeholders who have the power to the availability of resources that used for the operational activities of the company, such as labor, corporate and product markets over others (Chariri and Ghozali, 2007). So, here company does not only have a responsibility to fulfil the shareholders interest but also have a responsibility to fulfil the stakeholders interest by doing and disclosed CSR in their annual report to maintain the stability of the company.

2.2 Corporate Social Responsibility

Corporate Social Responsibility is not a newbie in the business world. Corporate Social Responsibility means that a corporation should be held accountable for any of its actions that affect people, their communities, and their environment, Lawrence et al., (2005). Based on The World Business Council of Sustainability Development, Corporate Social Responsibility is the continuing commitment by business to contribute to economic development while improving the quality of life of the workforce and their families as well as of the community and society at large.

Corporate Social Responsibility (CSR) is defined as the voluntary activities undertaken by a company to operate in an economic, social and environmentally sustainable manner. When companies operate in an economically, socially and environmentally responsible manner, and they do so transparently, it helps them succeed, in particular through encouraging shared value and social license. Management and mitigation of social and environmental risk factors are increasingly important for business success abroad, as the costs to companies of losing that social license, both in terms of share price and the bottom line may be significant. Corporate social responsibility (CSR) refers to a business practice that involves participating in initiatives that benefit society.

2.3 Disclosure

2.3.1 Definition of Disclosure

Conceptually, the disclosure is an integral part of financial reporting (Suwardjono, 2008). Disclosure means presenting useful information to those who need it. The information disclosed should be complete, clear, and able to represent the exact economic condition (Hutapea, 2014). Based on Evans (2003) in Suwardjono (2008), disclosure means supplying information in the financial statements themselves, the notes to the statements, and the supplementary associated with the disclosure statements. It does not extend to public or private statements made by management or information provided outside the financial statements.

More specifically, Wolk et al (2001) in Suwardjono (2008) interpreting the definition of disclosure as followed:

> "Broadly interpreted, disclosure is concerned with information in both the financial statements and supplementary communications including footnotes, post-statements events, management's discussion and analysis of operations for the fortcoming year, financial and operating forecasts, and additional financial statements covering segmental disclosure and extentions beyond historical cost."

Disclosure is often also interpreted as providing more information than what can be delivered in the form of formal financial statements (Suwardjono, 2008). This seems in line with the idea of the FASB in its conceptual framework as follows (SFAC No. 1, paragraph 5):

> "Although financial reporting and financial statements have essentially the same objectives, some useful information is better provided by financial statements and some is better provided, or can only be provided, by means of financial reporting other than financial statements."

2.3.2 Level of Disclosure

Level of disclosure is related to how much information should be disclosed. There are three levels of disclosure proposed by Hendriksen and Brenda (1992), which are:

a. Adequate Disclosure

   This implies a minimum amount of disclosure congruous with the negative objective of making the statement not misleading.

b. Fair Disclosure

   This implies an ethical objective of providing equal treatment for all potential readers.

c. Full Disclosure

   This implies the presentation of all relevant information. For some, it means the presentation of superfluous information that sometime becomes inappropriate.

2.3.3 Type of Disclosure

There are two kinds or two types of disclosure which are mandatory disclosure and voluntary disclosure.

a. Voluntary Disclosure

   Voluntary disclosure is the disclosure by the company beyond what is required by the accounting standards or regulations of regulatory bodies (Suwardjono, 2008).

b. Mandatory Disclosure

Mandatory disclosure is mandatory disclosure by the company as a form of government intervention to overcome the potential market failures.

2.3.4 Corporate Social Responsibility Disclosure

Disclosure about CSR in Indonesia first regulated in ACT No. 40 of 2007 about corporation and in Government Regulation No. 47 of 2012 concerning Social and Environmental Responsibility of Corporation. But both of those regulations did not explain about the items of social and environmental responsibility that must be disclosed. In August 2012, Ministry of Finance of the Republic of Indonesia through Capital Market and Financial Institution Supervisory Body (BAPEPAM-LK) issued Decision of the Chairman of Capital Market and Financial Institution Supervisory Body (BAPEPAM-LK) No. KEP-431/BL/2012 concerning the submission of annual report by listed company.

In Decision of the Chairman of Capital Market and Financial Institution Supervisory Body (BAPEPAM-LK) No. KEP-431/BL/2012, there is a regulation No. X.K.6 which is concerning the submission of annual report by listed company. In point 2.a.1.g said that an annual report must contain corporate social responsibility. Furthermore in point 2.h.1, BAPEPAM-LK required companies to disclose its CSR activities that cover policies, types of program, and cost incurred in the following aspects such as environmental; employment practices, health, and work safety; social and community development; and product responsibility.

2.4 Information Asymmetries

Information asymmetry is a condition describing that managers have access to information on the company's prospects which are not owned by outside parties (Sanjaya and Young, 2012). This condition will result in the magnitude of the opportunity manager, to do things that are beneficial to their interests (Palguna Putra, 2013).

There are two major types of information asymmetry (Scott, 2009). First is adverse selection. Adverse selection is a type of information asymmetry whereby one or more parties to a business transaction, or potential transaction, have an information advantage over other parties. The second is moral hazard. Moral hazard is a type of information asymmetry whereby one or more parties to a business transaction, or potential transaction, can observe their actions in fulfillment of the transaction but other parties cannot.

2.5 Earnings Quality

Earnings quality is an indicator of the quality of financial information. High quality financial information is derived from the high quality of financial reporting (Surifah, 2010). Earnings quality refers to the ability of reported earnings to reflect the company's true earnings, as well as the usefulness of reported earnings to predict future earnings. Earnings quality also refers to the stability, persistence and lack of variability in reported earnings. The evaluation of earnings quality is often difficult, because companies highlight a variety of earnings figures: revenues, operating earnings, net income, and pro forma earnings (Bellovary et al, 2005). Barragato and Markelevick (2008), states that earnings quality is of interest to users of financial statements because earnings are utilized in making contracting and investment decisions. Earnings quality means different things to different users of financial statements.

So far, no definitive measure or appropriate to measure the quality of earnings of a financial statement, only an approach that is being used to proxy the quality of earnings. Therefore, earnings quality measure used by the researchers could be different with other researchers (Surifah, 2010). This research will use earnings management through discretionary accruals as the proxy of earnings quality.

2.6 Positive Accounting Theory

Based on Scott (2009), for the purpose, the term “positive” refers to a theory that attempts to make good predictions of real-world events. Thus, positive accounting theory is concerned with predicting such actions as the choices of accounting policies by firm’s managers and how managers will respond to proposed new accounting standards. Positive accounting theory takes the view that firms organize themselves in the most efficient manner, so as to maximize their prospects for survival. Positive accounting theory has three hypotheses:

1. Bonus plan hypothesis

   Bonus plan hypothesis talks about managers of company with bonus plans are more likely to choose accounting procedures that shift reported earnings from future periods to the current period.

2. Debt covenant hypothesis

   Debt covenant hypothesis talks about the closer a company is to violation of accounting-based debt covenants, the more likely the company manager is to select accounting procedures that shift reported earnings from future periods to the current period.

3. Political cost hypothesis

   Political cost hypothesis talks about the greater the political cost faced by a firm, the more likely the manager is to choose accounting procedures that defer reported earnings from current to future periods. From those hypotheses, we can know that the existence of positive accounting theory is the door way of earnings management practices.

2.7 Earnings Management

Based on Scott (2009), earnings management is the choice by a manager of accounting policies, or actions affecting earnings, so as to achieve some specific reported earnings objective. Earnings management may be defined as "reasonable and legal management decision making and reporting intended to achieve stable and predictable financial results." Earnings management is not to be confused with illegal activities to manipulate financial statements and report results that do not reflect economic reality. Earnings management is the use of accounting techniques to produce financial reports that may paint an overly positive picture of a company's business activities and financial position. Earnings Management takes advantage of how accounting rules can be applied and are legitimately flexible when companies can incur expenses and recognize revenue. It can be difficult to differentiate these allowable practices from earnings fraud or manipulation. Earnings management theoretically represents this grey area, but it is often used as a synonym for earnings manipulation or earnings fraud.

Discretionary Accrual – Earnings Management

Accrual earnings management is the practice of earnings management which is carried out by the company through the accrual components in the financial statements. Accrual itself is recognition of where the transactions are recognized, recorded, and presented in the financial statements when incurred without regard whether the cash flow is received or paid. Because of the nature of accrual using assumptions or estimates, accruals are often used as a tool by management to manipulate earnings. Accrual policy is divided into two discretionary accruals and nondiscretionary accruals. Discretionary accrual policy is undertaken by the will of management with a specific purpose. In this case, discretionary accrual is closely related to earnings management because it is done over the management of the company in which management will make adjustments to earnings to meet specific interests.

2.8 Previous Research

Number of research	Researcher	Research title	Result
1.	Zhou and Lobo (2001)	Disclosure Quality and Earnings Management	Indicates that there is a statistically significant negative relationship between corporate disclosure and earnings management. Firms that disclose less tend to engage more in earnings management and vice versa.
2.	Yeh et al., (2014)	Can Information Transparency Improve Earnings Quality Attributes? Evidence from an Enhanced:	Find that there is a statistically reliable association between the level of information transparency and each of

		Disclosure Regime in Taiwan	these earnings attributes, implying that a disclosure mechanism design can enhance management accountability in financial reporting.
3.	Cui et al., (2012)	Does Corporate Social Responsibility Reduce Information Asymmetry?	Find that CSR activities reduce information asymmetry more than information asymmetry decreases CSR activities
4.	Sanjaya and Young (2012)	Voluntary Disclosure and Earnings Management at Bank Companies Listed in Indonesia Stock Exchange	The result of this study is voluntary disclosure negatively affects earnings management. The result indicates that more increased voluntary disclosure influences more decreased earnings management. Therefore, voluntary disclosure is very important for users of financial statements.
5.	I Gusti Bagus A. W. Palguna Putra (2013)	*Pengaruh Tingkat Pengungkapan Item Corporate Social Responsibility Terhadap Manajemen Laba (Studi pada Perusahaan yang Terdaftar di Indeks SRI-KEHATI Selama Tahun 2009–2011)*	Trying to prove the effect of the disclosure of the items in the social responsibility which is a voluntary disclosure towards earnings management. Results from this study demonstrate that the disclosure of the items of this CSR have influence on earnings management which has implications for the quality of earnings.
6.	Arvina Arief (2014)	*PENGARUH PENGUNGKAPAN CORPORATE SOCIAL*	Trying to examine the influence of corporate social responsibility

		RESPONSIBILITY TERHADAP MANAJEMEN LABA (Studi Kasus Pada Perusahaan Non Keuangan dan Jasa yang Terdaftar di BEI tahun 2010-2012)	disclosure on earning management practice. The result of this study show that corporate social responsibility disclosure not sifnificant influenced and have positively on earning management
7.	Yong tae Kim, Myung Seok Park, Benson Wier (2012)	Is Earnings Quality Associated with Corporate Social Responsibility?	Documented that increase in CSR performance is negatively associated with earnings management, with ethical managers engaging in enhanced CSR activities and less earnings management.
8.	Hong and Andersen (2011)	The Relationship Between Corporate Social Responsibility and Earnings Management: An Exploratory Study	Explore the relationship between corporate social responsibility (CSR) and earnings management (EM). Results show that more socially responsible firms have higher quality accruals and less activity-based EM, both of which impact financial reporting quality.
9.	Yip et al., (2011)	Corporate Social Responsibility Reporting and Earnings Management: The Role of Political Costs	Examine whether Corporate Social Responsibility (CSR) disclosure is related to earnings management and if the relationship is mitigated by political cost considerations or by the firm's ethical predisposition. Find a significant

			relationship between CSR reporting and earnings management, and more specifically, we find evidence of a negative (complementary) relationship in the oil and gas industry while we find evidence of a positive (substitutive) relationship in the food industry.

2.9 Hypothesis Development

CSR disclosure is believed as an action to fulfill the stakeholders' interest. CSR disclosure considered increasingly taking a role in the present due to the shift in the concept of profit which began to lead to the concept of the triple bottom line (profit, planet, people) initiated by John Elkington and increasingly into the mainstream of business ethics (Palguna Putra, 2013). It is in line with Kim et al., (2012) statement that CSR is an issue of growing interest, and the reporting of socially responsible activity is becoming more prevalent as investors, customers, and other stakeholders demand greater transparency about all aspects of business.

In Indonesia there are some issues arise about the implementation of CSR and one of it is company's transparency issue in disclosing the budget and activity of CSR. It is proved by news on *RiauSatu.com* on April 2015 which stated that *"Ketua Pansus CSR berharap Pemerintah dan Perusahaan Transparan."* The news talked about the transparency of CSR's budget and the company's CSR activities. Having problem in transparency will cause the increasing in information asymmetry between company and stakeholder. Richardson (1998) stated that when information asymmetry is high, stakeholders do not have sufficient resources or access to relevant information to monitor manager's actions. It leads to creation of opportunities for earnings management practices. Dye (1988) and Trueman and Titman (1988) in Zhou and Lobo (2001) show analytically that the existence of information asymmetry between management and shareholders is a necessary condition for earnings management. Thus, when earnings management increases it will affect quality of earnings of company.

Glosten and Milgrom (1985) in Zhou and Lobo (2001) stated that information asymmetry will decrease if the level of corporate disclosure increases. It is also proved by Lang and Lundholm (1993) in Zhou and Lobo (2001), which state that firms having greater incentives to disclose more information to mitigate adverse selection when there is greater information asymmetry. Sanjaya and Young (2012) found that the increasing on presentation of voluntary disclosure, information asymmetry can be reduced so that earnings management can be prevented. Zhao and Lobo (2001) also found negative relationship between corporate disclosure and earnings management. Firms that disclose less tend to engage more in earnings management and vice versa. When company less engage in earnings management their quality of earnings will increase. Many researches already test about the influence of disclosure to earnings management or disclosure to earnings quality, and they have the same results which is disclosure negatively influence earnings management and positively influence earnings quality (Zhou and Lobo, 2001; Yeh et al., 2014; Sanjaya and Young, 2012; Blanco et al., 2014).

Many researchers research about the influence and the association between CSR and earnings quality or CSR and earnings management, and the results is mix. Some researchers find that CSR has negative influence and association with earnings management and will give positive impact to earnings quality (Hong and Andersen, 2011; Kim et al., 2012; Ekawati, 2012; Palguna Putra, 2013; Isyanto, 2014). On the other hand, other researchers state that CSR has positive influence and association with earnings management and will give negative impact to earnings quality (Chih et al., 2008; Yip et al., 2011; Arief, 2014).

Due to the mix results from previous researchers then the hypothesis can be formulated as follow:

Ha: The Level of Corporate Social Responsibility Disclosures Influence the Earnings Quality