



Relationship of corporate social responsibility and corporate governance with earnings management: A review

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Abstract

This paper aims to review the existing literature on the relationship of Corporate Social Responsibility (CSR) and Corporate Governance (CG) with Earnings Management (EM) in different countries. Since there have been so many corporate frauds in recent years, corporate governance and earnings management have received more attention. The unexpected failures of major corporations, which are typically the result of poor governance, had a severe impact on the global economies. This paper provides insights into the prior literature related to the association between CSR activities and earnings management practices. It also reviews the existing research on several conceptual models of corporate governance and demonstrates how effective corporate governance (CG) results in regulating earnings management practices. Findings of the preceding studies related to CSR-EM give mixed results, most of the findings suggested that there is a negative relationship, some found a positive relationship whereas some revealed that there is no association between CSR and EM. Most of the results demonstrated that socially responsible companies with a good CG mechanism significantly reduce earnings management (EM) practices. This review study adds to the array of existing literature on the association of corporate social responsibility, corporate governance with earnings management.

Keywords: corporate social responsibility (CSR), corporate governance (CG), and earnings management (EM)

Introduction

Corporate social responsibility (CSR) and corporate governance (CG) are two important concepts that gained considerable attention in the recent literature. CSR pertains to a company's ethical and social obligations towards society and the environment, while CG refers to the policies, procedures, and rules employed to oversee a company's activities and ensure its long-term sustainability. CSR and CG both have been shown to have a substantial impact on a firm's financial performance, particularly concerning its management of earnings. Earnings Management (EM) is a process by which executives distort results to satisfy contractual obligations that are contingent on earnings being reported or to mislead some stakeholders about the firm's true economic performance (Healy and Wahlen, 1999) ^[18]. Companies may engage in earnings management to meet the expectations of shareholders or analysts, or to smooth out fluctuations in earnings over time. However, earnings management can have serious consequences for the company and its stakeholders if it is done in a way that violates accounting standards or misleads investors. World's biggest corporate accounting scandals such as Enron (USA), WorldCom (USA), Tyco (2002), Satyam Computers (India), and many others disrupted the global economy, reiterated the need for a thorough investigation into the authenticity of the financial statements and reports, and fuelled global calls for enhanced corporate governance (CG) mechanisms. All these scandals, occurred when managers manipulated the earnings by managing the financial statements at their discretion to report the earnings as they desired (Agrawal and Chadha, 2005). It raised the concern for researchers to study the relationship of good CG mechanism with Earnings Management (EM). CSR activities and good CG mechanisms help in reducing EM practices. Ghaleb *et al.* (2021) ^[15], stated that CSR initiatives result in a decrease in

real EM practices and enhance the reporting quality, further, having more female directors as gender diversity in the board (BGEND) moderates the CSR-EM relationship. Female directors enhance the board's monitoring responsibility and have a positive impact on mitigating earnings manipulation through real activities, both directly and indirectly. This paper intends to provide an overview of the existing literature by reviewing the relationships of CSR and CG with EM.

Corporate Social Responsibility (CSR) and Earnings Management (EM)

In recent years, corporate social responsibility (CSR) has gained popularity as a business strategy. Corporate Social Responsibility (CSR) activity is based on the legitimacy theory, which holds that a company must continue to work to demonstrate that its operations have been in accordance with the laws, standards, and moral precepts of the society and environment in which it is situated. This ensures that the company's operations are regarded as legitimate by the public (Deegan, 2002) ^[11]. CSR is a wider term that encompasses an array of initiatives performed by companies to minimize their adverse and maximize their positive influence on society (both in a social and ecological sense) (Carroll, 1999) ^[18]. According to the CSR philosophy, companies have a duty to not only make a profit but also to positively impact society. However, there are concerns that some businesses may use CSR as a tool to manipulate their financial statements, particularly in the area of earnings management. Earnings management is the practice of managers manipulating profits in order to influence stock market opinions boost management remuneration, lower the likelihood of breaching contractual obligations, and prevent regulatory interference (Healy and Wahlen, 1999) ^[18]. The relationship between EM and CSR has been studied by

multiple nations all over the world. Findings of the prior literature review, indicate that some businesses may engage in EM practices less when they engage in CSR activities, while others use CSR activities to cover up EM practices by enticing them with CSR disclosure. The behaviour of each company varies depending on the circumstances. Hong and Andersen (2011) ^[21] find that CSR activities play a vital role in mitigating earnings management practices, whereas, Hemingway and Maclagan, (2004) ^[19] revealed that CSR is

used by company managers to conceal corporate misconduct in their financial reports and statements because the trust generated by managers' CSR initiatives can mask such wrongdoings. This paper aims to give an overview of existing literature on the relationship between CSR and EM to find out the various types of relationships that exist between EM and CSR, and the type of procedure that has been used to examine the association.

Table 1: Literature review on the relationship between Corporate Social Responsibility and Earnings Management

Authors, years	Sample	Purpose	Methodology	Findings
Hong and Andersen (2011) ^[21]	8,078 firm-year observations of non-financial U.S. firms (1995 - 2005)	Explored the relationship between corporate social responsibility (CSR) and earnings management (EM).	Based on Kinder, Lydenberg, and Domini (KLD) database, the CSR index was built and earnings management was based on accruals quality.	More socially responsible companies have less activity-based EM with higher quality accruals, which further impact the quality of financial reporting.
Grougiou <i>et al.</i> (2014) ^[16]	116 listed commercial banks in the U.S. (2003–2007)	Examined the bi-directional relationship between CSR and EM in commercial banks.	The two-stage least square 2SLS regression analysis was used to test the relationship. CSR was calculated based on KLD ratings. EM was measured by using LLPs and RSLGs recorded by the banks.	There is no bidirectional relationship between CSR-EM, as there is a significant and positive relationship between EM and CSR, but the reverse relationship is insignificant.
Ben Amar and Chakroun (2018) ^[5]	119 French non-financial firms listed on the CAC all tradable index (2010 - 2014)	Explored the impact of corporate social responsibility (CSR) on earnings management.	EM was measured by discretionary accruals using the cash flow from operations. Panel data with random effects was used to estimate each regression.	There is a negative impact of CSR on earnings management, companies with great CSR conduct less manipulation of earnings.
Faisal <i>et al.</i> (2018) ^[14]	479 public listed companies listed in the (IDX) Indonesia stock exchange. (2012-2013)	Examined whether the relationship between corporate social responsibility disclosure (CSR D) and EM is a complement or substitute mechanism for the firms.	The two-stage least square (2SLS) regression analysis was employed to test the relationship. Content analysis was used to measure the items for CSR disclosure, EM was detected using real activities manipulation (RAM.)	The relationship between CSR D and EM is a substitute mechanism and the firms having high CSR D are less engaged in earnings management.
Moratis and Egmond (2018) ^[29]	sample of 5494 observations of US-listed companies (2003-2009)	Examined the association between CSR performance level and the EM level of firms.	EM was estimated with discretionary accruals by using a modified Jones model. CSR performance is measured based on KLD database. Regression analysis was used to test the relationship.	there is no link between earnings management and CSR and the companies with high environmental impact group do not appear to implement EM but shows a greater level of CSR performance.
Sial <i>et al.</i> (2018) ^[37]	3,481 observations of Chinese firms listed on the Shanghai and Shenzhen Stock Exchanges (2009–2015)	Examined the moderating role of EM on the relationship between CSR and firm performance.	The generalized method of moments (GMM) analysis has been used. For CSR, ratings provided by Rankins (RKS) were used, and Tobin's Q for firm performance and earnings management was measured by discretionary accruals and real earnings management.	CSR has a positive significant relationship with a firm's performance and earnings management negatively moderates this relationship between CSR and firm performance.
Yousf Almahrog <i>et al.</i> (2018) ^[39]	515 firm-year observations listed in the UK FTSE 350 index (2008- 2010)	Role of corporate social responsibility (CSR) in limiting the extreme practices in earnings management (EM)	to measure the level of CSR, content analysis and disclosure index were used. EM was measured based on discretionary accruals by using a cross-sectional version of the modified Jones model.	The findings reveal that companies with a higher commitment to CSR activities are less likely to manage earnings through accruals.
Kim <i>et al.</i> (2019) ^[23]	521 listed Chinese firms (2009-2014)	Examined the impact of corporate social responsibility (CSR) on accrual and real-based earnings management (EM) practices.	CSR annual scores of firms from Rankings Ratings (RKS) were used and OLS and 2SLS regression were used to analyze the impact. EM was measured by using accrual-based (AEM) and real activity-based (REM) earnings management.	Enhanced CSR activities decrease both accrual and real EM practices. However, the firms in more developed regions institutionally and state-controlled firms are engaged in more CSR practices and are likely to increase REM practices.

Mohmed <i>et al.</i> (2020) ^[28]	Top 100 companies from the Egyptian (S&P/ESG index) (2007-2015)	Examined the relationship between corporate social responsibility (CSR) and earnings quality.	CSR annual scores from Egypt Environmental, Social, and Governance (S&P/ESG) index were used for CSR, and 2SLS regression analysis to test the relationship. EM was measured with discretionary accruals by the modified Jones model and model of asymmetric recognition of gains and losses.	CSR is positively related to earnings quality. CSR improved the quality of the earnings of only top CSR-scoring enterprises by accrual earnings management. Companies with relatively low CSR scores might utilize CSR to "greenwash" weaker earnings.
Rezaee <i>et al.</i> (2020) ^[34]	2580 Chinese listed companies (2009-2015).	Explored the relationship between corporate social responsibility (CSR) and earnings quality.	Data on CSR rankings from Rankins (RKS) and four measures of earnings quality with were used for analysing the relationship.	Firms with higher CSR ratings have more consistent earnings and they are less likely to engage in earnings management than non-CSR companies. Further, the association between CSR disclosures and earnings quality is moderated by state ownership and marketization.
Kumala and Siregar (2021) ^[26]	105 firm-years of mining companies listed on the Indonesia Stock Exchange (IDX) (2012-2014)	Explored the association of corporate social responsibility (CSR), family ownership, and earnings management.	For earnings management absolute value of performance-adjusted discretionary accruals (ADA) was used. CSR is based on the level of CSRDs, with the global reporting initiative (GRI) guidelines. regression analysis for examining the relationship was used.	There is a negative relationship between corporate social responsibility disclosures (CSRDS) and earnings management and becomes more stronger due to family ownership as there is a positive relationship between family ownership and earnings management.
Martinez-Martinez <i>et al.</i> (2021) ^[27]	317 Spanish Small and medium enterprises SMEs	Examined the relationship between corporate social responsibility (CSR) and determinants of earnings management (EM) in small- and medium-sized companies (SMEs) with the relevance of sector life cycle stage.	EM was calculated by the Jones model. Bivariate and multiple regression analysis were used for examining the relationship.	Companies with sales expansion or contraction are more responsive to earnings management activities than companies with consolidated sales. further, SMEs with stable sales show higher CSR performance and reduced earnings management in mature industries. Companies with consistent sales are less engaged in EM.
Pasko <i>et al.</i> (2021) ^[32]	3538 Chinese listed firms (2009 – 2019)	Investigated whether a company's corporate social responsibility (CSR) stance impacts its reporting incentives in relation to the degree of earning management.	Modified Jones model of discretionary accruals, used as a measure of earning management. Multivariate regression was used for the analysis.	Findings revealed that there exists a significant positive relationship between CSR activity and the degree of earnings management. CSR-active companies control earnings more actively than CSR-inactive firms in China.
Palacios-Manzano <i>et al.</i> (2021) ^[31]	100 most prominent Spanish companies as per the Corporate Reputation Business Monitor (MERCOS) index. (2011 - 2015)	Explored the impact of a firm's CSR attitude on its reporting incentives in terms of accrual-based earnings management.	Accrual-based EM was measured by the cross-sectional version of the modified Jones model. CSR was determined based on the ratings provided by (the MERCOS) database. 2SLS regression was used for the analysis.	CSR practises increase the quality of earnings and it has a negative and detrimental effect on earnings management.
Hickman <i>et al.</i> (2021) ^[20]	All listed non-financial companies listed on the Bombay stock exchange BSE in India (2012 - 2017)	Investigating the impact of voluntary and mandatory CSR in India on earnings management.	Absolute values of discretionary accruals and real activities were used for earnings management. CSR Ratio (CSR expenses divided by net income) was used to calculate the CSR. Regression analysis was used to examine the relationship.	Voluntarily reporting CSR firms prior to the act, are more engaged in earnings management than other firms, whereas, after the enactment of the act, the companies with mandated CSR are less engaged in earnings management.
Ehsan <i>et al.</i> (2022) ^[13]	160 non-financial firms listed on Pakistan Stock Exchange (PSE). (2009 - 2018)	To study whether the association corporate social responsibility (CSR) and earnings management (EM) are sustainable or opportunistic.	For the analysis two-stage least square (2SLS) and pooled ordinary least square (POLS) regressions were used. EM was measured based on accrual and real activities. CSR monetary spending ratios and (CSR MSR) and CSR transparency indexes were used.	Findings reveal that the company's commitment to CSR is based on the long-term perspective, and the CSR-EM relationship is negative. Further, CSR-AEM has a significant positive relationship whereas, there is a negative relationship between CSR and REM.

Table 1 provides an overview of available research literature in different countries regarding the relationship between corporate social responsibility (CSR) and earnings management (EM). Findings of the prior studies give mixed

results, however, most of the studies found that CSR-EM has a negative relationship as CSR activities reduces the practices of earnings management by companies and increases the quality of earnings. Some studies showed that

CSR-EM has a positive relationship suggesting that some firms use CSR activities to manipulate the earnings, whereas, few studies revealed that there is no connection.

Corporate Governance and Earnings Management

The relationship between good corporate governance (CG) mechanism and earnings management became a topic that has been receiving considerable attention from regulators and researchers. Corporate governance refers to the system of rules, practices, and processes that are used by a company to manage and control its operations, and maintains the balance between the interests of the company’s many stakeholders such as shareholders, financiers, top management executives, consumers, suppliers, creditors, employees, the government, and other internal and external interest holders (Cadbury, 1992) [7]. One key aspect of corporate governance is the management of earnings, which refers to the manipulation of financial statements by companies to either inflate or deflate their earnings figures. According to Schipper (1989) [36], earnings management is the opportunistic behavior of managers to attain certain goals and objectives, such as the desire to deliver consistent financial performance reports, by altering the numbers

reported in financial statements. It is a process in which, without breaching the Generally Accepted Accounting Principles (GAAP), executives may utilize a variety of accounting approaches at their discretion and manipulate the reported earnings to meet the expectations of analysts or shareholders, to avoid loan covenants, or to smooth out fluctuations in earnings over time. Corporate governance plays an important role in mitigating the risks associated with earnings management. Based on the available literature, effective corporate governance framework attributes include composition, size, functions, gender diversity, and characteristics of the board, independent audit committees, CEO duality, ownership structure, institutional ownership, and independent directors. It is necessary to create a good CG mechanism that helps to identify and deter earnings management practices that are unethical and promote transparency and accountability in the companies. In India, (clause 49), of the Securities and Exchange Board of India (SEBI) act, made mandatory guidelines for listed companies regarding the CG mechanism to create a good corporate governance framework and to align it with the global standards.

Table 2: Literature review on the relationship between Corporate Governance and Earnings Management

Authors, years	Sample	Purpose	Methodology	Findings
Chen <i>et al.</i> (2007) [9]	654 Taiwan-listed companies (2002-2003)	Examined the association between corporate governance mandated by Corporate Governance Best-Practice Principles (CGBPP) and earnings management.	Measuring EM by using a modified Jones model for discretionary accruals and CGBPP components are used for corporate governance and regression analysis was used to examine the relationship.	The enactment and implementation of CGBPP lowered the earnings management practices in the firms of Taiwan.
Cornett <i>et al.</i> (2009) [10]	46 large bank holding companies (BHCs) in the United States (1994-2002)	Impact of corporate governance mechanisms on earnings and earning management at large U.S. bank holding companies.	OLS (ordinary least square) and 2SLS (two-stage least square) regression were used.	CEO pay-for-performance sensitivity (PPS) is positively related to earnings and EM. However, board independence and capital are positively related to earnings but negatively related to earnings management.
Kang and Kim (2011) [22]	1,104 firm-year observations, of non-financial firms listed on the Korean Stock Exchange (2005-2007)	Examined the association between corporate governance, real activity-based earnings management, and firm performance.	Corporate governance was measured by the corporate index, for practises firm performance (Tobin’s Q) and OLS and 2SLS regression were used to test the association.	A well-established governance system reduces the real activity-based earnings management which further strengthens the relationship between corporate governance and firm performance.
Kouki <i>et al.</i> (2011) [25]	171 U.S. firms (1998 – 2005).	Examined whether corporate governance mechanism constrains earnings management.	EM was measured by proxy of Discretionary accruals (DA), and panel regression (fixed-effect) to analyze the impact.	Large board size, independency of nominating and audit committees, and non-manager membership as CG mechanism significantly reduce earnings management.
Prencipe & Bar-Yosef (2011) [33]	Non-financial 122 firms for the year 2003 and 127 firms for the year 2004, listed on the Milan Stock Exchange (MSE) (2003-2004)	Analysed the impact of Board independence on reducing earnings management in family-controlled companies.	Board independence is included the proportion of independent directors on the board and the lack of a chief executive officer (CEO)-board chairman duality function and regression analysis.	The impact of board independence, in family-controlled companies and lack of CEO- board chairman duality is weaker and less effective on earnings management.
Abed <i>et al.</i> (2012) [2]	329 firm observations of non-financial firms in Jordan, listed on the Amman Stock Exchange (ASE), (2006-2009)	Examined the relationship between earnings management activities and characteristics of corporate governance mechanism.	Earnings management is measured by discretionary accruals using modified Jones models. CG instruments include independent members in the board of directors, the percentage of insider ownership, the size of the board of directors, and the role duality (CEO/chairman).	The size of the board of directors is the only component that has a significant relationship with earnings management.

Alareeni (2018) ^[4]	20 listed companies in Bahrain Bourse (2011-2015)	Examined the impact of a set of corporate governance characteristics on EM practices.	The EM level was measured using discretionary accruals (DA). A panel regression model was used to test the study hypotheses.	EM is negatively correlated with board size and board independence and internal ownership both are positively correlated with EM, whereas, CEO duality does not have any impact on EM.
Suyono and Farooque (2018) ^[38]	29 listed manufacturing companies in the Indonesian Stock Exchange (IDX) (2010-2014)	Investigating the moderating role of earnings management on the relationship between corporate governance and corporate social responsibility.	OLS technique is used to analyse the data. EM was measured by using a modified Jones model.	independent boards, institutional ownership, and managerial ownership have a significant deterrent impact on earnings management, while the board of directors and institutional ownership have a significant positive impact on CSR, and there is a strong moderation effect of earnings management.
Diri <i>et al.</i> (2020) ^[12]	6873 industry-year observation (1989-2016)	Examined the mitigating role of corporate governance in using accrual and real earnings activities in high and low-concentrated markets.	OLS regression was used to analyse the data. EM was measured by using the Stubben model to calculate accrual earnings and the Gunny model to calculate real earnings.	Firms operating in concentrated markets use more accrual and real earnings management compared to those in non-concentrated markets. Corporate governance as the efficient board, mitigates the earnings management in non-concentrated markets.
Kjærland <i>et al.</i> (2020) ^[24]	49 listed companies on the Oslo Stock Exchange (2014-2017)	Examined the relationship between Nordic corporate governance practices and earnings management.	EM was calculated by discretionary accruals using the Kothari model, and multivariate regression on panel data to analyse the hypothesis.	Employee representation on the board and the presence of an audit committee both help in constraining earnings management, whereas board independence and share ownership by directors positively impact earnings management, while board activity and directors as majority shareholders show an insignificant relation to earnings management.
Nasiri and Ramakrishnan (2020) ^[30]	84 companies listed in Bursa Malaysia from the index of FTSE Top 100. (2011-2015)	Explored the role of corporate governance, in the relationship between earnings management and firm performance.	Panel data analysis was used to analyse the data ROA, EVA, ROE, and Tobin's Q, used as firm performance measures. EM was calculated by discretionary accruals (DA).	Weakly managed companies or companies working in a poor governance system use more earnings management practices by modifying DAs than well-managed companies which further leads to a decline in corporate performance.
Saona <i>et al.</i> (2020) ^[35]	120 Spanish-listed non-financial firms (2006 - 2014)	Investigated the impact of the board of directors' features and ownership structure of corporate governance system (firm-level and country-level) on earnings management.	Regression analysis was used for the study. EM was calculated with absolute values of discretionary accruals.	Larger independent boards consisted of female members, independent outside directors with the audit committee, increased voting rights of the shareholder constrains the earnings management, whereas, board duality increases the likelihood of earnings management and there exists an inverse U-shaped relationship between insiders' ownership and the earnings manipulation.
Abdou <i>et al.</i> (2021) ^[1]	66 non-financial firms in the UK and 40 non-financial firms in Egypt (2004 - 2010)	Examined the association between corporate governance (CG) and earnings management (EM) and whether governance quality moderates the relationship between EM and CG.	OLS regressions and generalized regression neural networks (GRNNs) were used to analyse the relationship EM was measured by the modified Jones model.	UK firms with smaller boards, while firms in Egypt having larger boards, both with a low percentage of female directors and dominated by independent outside directors, have lower levels of EM.
Biswas <i>et al.</i> (2022) ^[6]	22 publicly traded commercial banks in India. (2010 – 2019).	Role of corporate governance (CG) on earnings management (EM) with the role of board gender diversity in CG.	CG index was developed using Principal Component Analysis (PCA) and panel-corrected standard error (PCSE) regression to analyze the relationship. Loan loss provision (LLP) and realized securities gains and losses (RSGL) were used to estimate EM in banks.	Corporate Governance has a significant negative impact on EM, and there exists a positive relationship between the gender diversity of boards and EM.
Hassan <i>et al.</i> (2022) ^[17]	35 non-bank companies listed on the Palestine Exchange (PEX) (2012-2019).	Examined the impact of certain board characteristics, ownership structures, and audit committee on earnings management behaviour in an unstable economic and political environment.	A fixed effects regression model was used for the analysis and a cross-sectional modified version of the Jones model was used for EM. The code of CG in Palestine issued by the National Committee of Governance was used for CG attributes.	Board characteristics and ownership systems in Palestine are ineffective in constraining earnings management practices. However, there is weak evidence to show that ownership concentration has some effect in curbing earnings manipulation.

Table 2 provides an overview of the existing literature on the relationship between corporate governance and earnings management. While considering the relationship of individual corporate governance attributes (board composition, size, characteristics, functions, gender diversity in board, independent audit committees, CEO duality, ownership structure, institutional ownership, independent directors) with EM, the findings of numerous research studies are contradictory. However, from a broader viewpoint, it has been demonstrated that corporate governance practices and earnings management has a significant relationship, suggesting that good CG mechanisms reduce the earnings management practices by companies.

Conclusion

This study reviews the prior literature to determine the range of possible relationships between CSR-EM and CG-EM, the types of association, and the methods employed to assess those relationships. As per the empirical literature review, the association between CSR and EM appears to have mixed results, but on an overall basis, the literature shows that corporate social responsibility is important in reducing earnings management practices. Companies that prioritize CSR, are more likely to act transparently and morally, consider the interests of their stakeholders, and have a robust governance structure. Further, the literature reveals that various attributes of CG mechanisms such as audit committee, board composition, ownership structure, and CEO duality serve as a restraint on EM practices and restrict the possibility of earnings manipulation on a larger scale. This review study adds to the array of literature on the relationship of corporate governance, and corporate social responsibility with earnings management by offering a thorough evaluation of the numerous studies carried out in this area. Even though numerous studies have been conducted, most of them are concentrated on companies in developed countries so there is still ample opportunity for additional research in developing countries like India. The current literature review will greatly aid future research in this area. This study provides researchers, academicians, policymakers, and practitioners with a variety of opportunities and advantages such as the creation of a framework for corporate governance practices and CSR activities and their impact on various levels of earnings management and overall firm performance.

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