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Correlation between Social Responsibility and Financial Performance: Mediating Role of Real Earning Management

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Abstract:-
Purpose: This study aimed to examine direct effect of social responsibility on financial performance as well as through earnings management as a mediating variable.

Design/methodology/approach: This study used in secondary data involving 36 companies listed on the Islamic Jakarta Index (JII) for the period 2014-2021. This study used partial least square and carried out with the help of software Smart PLS 3.0.

Findings: The results showed that CSR has a positive insignificant effect on financial performance and earnings management. Meanwhile, the results showed that earnings management has a negative significant effect on financial performance. But earnings management can partially mediate the effect of the CSR on financial performance

Keywords:- *Earning Management, Financial Performance, Jakarta Islamic Index.*

I. INTRODUCTION

The issuance of the first sharia mutual fund in 1997, became an early milestone in the development of the Sharia capital market in Indonesia. This was followed by the launch of the Jakarta Islamic Index (JII) as the first sharia stock index. JII consists of 30 Islamic companies that have the highest market capitalization value. Thus, the company's capital indexed in JII is available in large quantities, so it had more significant opportunity to create profits from production activities. Therefore, JII indexed companies are considered to have a better level of financial performance compared to other sharia companies listed on the Indonesia Sharia Stock Exchange.

Mahrani et al., (2018) stated that the implementation of social responsibility can improve financial performance. The company's involvement with social responsibility can indirectly improve the quality of its relationships with stakeholders. The company will gain legitimacy and trust from them so the company's sales increased rapidly. However, often the investment intended for social activities is seen as an inefficient cost item. Walley & Whitehead (1994) stated that the implementation of social responsibility can be a threat to company profitability. This is because the implementation process requires large amounts of funds to provide technology that supports and ensures the program is implemented properly.

Studies about social responsibility's effect on financial performance have been conducted extensively. But there are still inconsistencies among the existing study's results. Mahrani et al., (2018) that involved 102 companies listed on the Indonesian Stock Exchange, provided empirical evidence that CSR has a positive effect on financial performance. While Elouidani et al., (2015) stated that commitment to CSR that implemented in developing countries, won't improve the company's performance and value in the first few years of implementation.

Previous research conducted by Mahrani et al (2018) used earnings management as an intervening variable. This research aimed to re-examine the role of earnings management in mediating the relationship between CSR and financial performance. Disclosure level of corporate social responsibility was measured using the ISR index and also used cash flow operation as the proxy of earning management that could mediate the relationship between CSR with the company's financial performance.

Incentive differences received by managers and shareholders also contributed to opportunistic actions by managers by utilizing the flexibility of accounting standards to create distortions in reported earnings. Based on stakeholder theory, this action will have a negative impact on the company's performance. This research is a replication of Mahrani's (2018) research. This paper will be followed by an overview of the literature review, research methods, results, discussion, also conclusions.

II. LITERATURE REVIEW

A. Theory Review

a) Agency Theory
Jensen and Meckling (1976) describe the agency relationship as a relationship between the company owner (principal) and the agent, with the delegation of the decision-making authority to the agent. Contrary to steward theory, agency theory explains that managers as managers of corporate resources prioritize their personal interests. Managers are described as internal parties who try to manipulate their reports so that their performance appears better from the investor's and other stakeholders' points of view. Because managers have more flexible access to internal information, this condition allows managers to choose and sort out the information they will disclose. This action open up the possibility of asymmetry information between

managers as an agents and stakeholders, especially owners.

b) Signalling Theory
Brigham & Houston (2014) define this theory as an investor's perspective on information that company managers provide in their annual reports as a certain signal to describe the company's ability to take opportunities to increase value in the future. The main purpose of this action is to improve the quality of the company in the future when compared to other companies. Freeman (1984) concluded that the real purpose of a company is to meet the needs of stakeholders, i.e. those affected by the decisions taken by the company.

c) Financial Performance
According to IAI (2007), financial performance is the company's ability to manage and control its resources. The performance of sharia-based companies, in general, is a description of the achievements of the related companies in their operational activities.

d) Islamic Social Reporting
Islamic Social Reporting (ISR) is a standard for assessing the social performance of sharia-based companies that is built on the principles of Islamic law. This index was built with the aim of providing convenience for sharia-based companies in making financial disclosures and fulfilling responsibilities to stakeholders.

e) Earnings Management
Real earnings management is the act of manipulating company profits through manipulation of the company's operational activities within a certain period (Kariasih, 2011). Earnings management is carried out by manipulating operating activities within a certain accounting period in order to avoid reporting losses on the company's operating profit.

B. Hypotheses Development

a) The effect of ISR on financial performance.
Cornell and Shapiro (1987); Donaldson and Preston (1995), as well as scientists who support stakeholder theory argue that by satisfying the needs of various stakeholder groups will result in increased company performance. On the other hand, ignoring the needs of stakeholders can have a negative impact on the company's financial performance.

Research that proves that CSR has a positive effect on financial performance, includes research conducted by Mahrani et al. (2018), Dakhli (2021), Saadaoui et al. (2022), and Saad et al. (2021). Based on the description, the proposed hypothesis is:

H1. ISR affects the company's financial performance.

b) The effect of ISR on Real Earning Management
Voluntary disclosure of social responsibility is considered to be able to minimize earnings management practices in companies. This is because, socially responsible companies have the view that earnings management practices are unethical and contrary to what is expected by stakeholders. This opinion is supported by the research results of Rido and Faisal (2015) which state that companies with broader social responsibility tend to minimize earnings management practices.

Research that proves that CSR has a positive effect on Earnings management, includes research conducted by Chih et. al (2008), Kim et. al (2011), and Prasetyo et. al (2021). The research conducted by Wardani dan Santi (2018), and Itan (2020) found empirical evidence that CSR has no effect on earning management. Based on the description, the proposed hypothesis is:

H2. ISR affects earnings management

The effect of Real Earning Management on financial performance Earnings management, either real or accrual, is considered capable of having an impact on company performance, both positive and negative, based on the pattern of implementing earnings management itself. For example, by applying the bath pattern, currently reported earnings will be smaller than they should be because managers seek to apply future costs to the present to increase the chances of earning larger profits in the future.

Research that proves that Earnings management has a negative effect on financial performance, including research conducted by Taylor dan Xu (2010), Tan dan Jamal (2006), and Wang dan Zheng (2020). Based on this description, the proposed hypothesis is:

H3. REM affects earnings management

c) The Effect of ISR on Financial Performance mediated by Earning Management
Companies that disclose ISR more broadly tend to minimize earnings management practices (Richardo et. al, 2015) because earnings management actions are considered less ethical and contrary to what is expected by stakeholders. The extent of ISR disclosure accompanied by a decline in earnings management practices can create investor confidence.

This opinion is supported by the research results of Chih et. al (2008) which states that CSR is able to increase transparency and minimize the opportunity for management to manipulate earnings. Liu et. al (2017) and Sial et. al (2018) in his research explains that the relationship between CSR and company performance can be mediated by earnings

management. The results of Itan's (2020) study provide new empirical evidence that earnings management fails to mediate the relationship between CSR and firm performance for family-owned firms.

H4. ISR affects financial performance through earning management.

III. RESEARCH METHOD

This study uses an explanatory pattern that aims to explain the position and correlation between the variables studied. While the type of relationship used in this study is causal design because the purpose of this study is to determine the effect of independent variables on variables.

A. Conceptual Framework

The purpose of establishing a company is to maximize shareholder wealth through increasing company value (Brigham and Houston, 2001). The implementation of social responsibility can improve the company's financial performance. According to Andayani (2008), disclosure of social responsibility can give the impression of a positive image of the company. A positive company image will increase legitimacy (recognition) from stakeholders so that it can foster public trust in the company to buy its products and can increase sales growth (Ratri, 2017).

Companies that disclose ISR higher then others, tend to minimize earnings management practices (Richardo et. al, 2015) because earnings management actions are considered less ethical and contrary to what is expected by stakeholders. The extent of ISR disclosure accompanied by a decline in earnings management practices can create investor confidence. Based on those explanations, the relationship between variables in this study can be explained through the research concept map in figure 1.

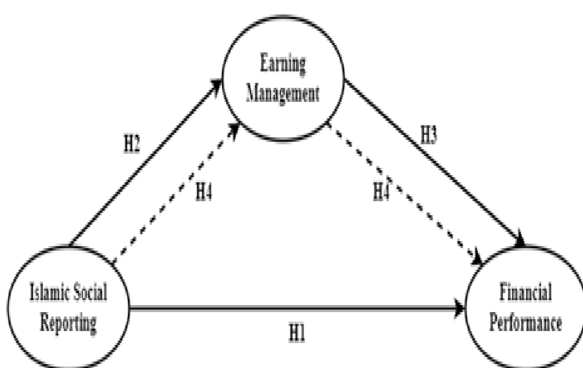

Fig. 1: Conceptual Framework

B. Operational definition and variables measurement

- Financial performance. Financial performance is defined as the company's ability to manage and control its resources (IAI, 2007 in Mahrani, 2018). The return on assets ratio was used to measure the financial performance in this research.
- Social responsibility. The social responsibility variable in this study is defined as all company activities that are not based on the legal coercion of a country in which the company operates and are not aimed for taking profit but for social purposes only (McWilliams and Siegel, 2001 in Mahrani, 2018). The measurement of CSR in this research used ISR index. Islamic Social Reporting (ISR) is a standard for assessing the social performance of sharia-based companies that is built on the principles of Islamic law. Companies that disclose items of ISR will be assigned a value of 1, while those not expressing are assigned a value of 0. Here is the formula used in this study:

$$ISR = \frac{Jumlah\ Item\ yang\ Diungkapkan}{Jumlah\ semua\ item\ yang\ seharusnya\ diungkapkan} x\ 100\%$$

- Earnings management. This study adopts the opinion of Roychowdhury (2006) in measuring real earnings management, one of which is by using a discretionary cash flow approach. The formula used to perform the calculation is:

$$\mathbf{CFO_{it} / A_{it\text{-}1} = \alpha_0 + \alpha_1 (1 / A_{it\text{-}1}) + \beta_1 (Sit / A_{it\text{-}1}) + \beta_2 (\Delta S_{it} / A_{it\text{-}1}) + e ....(1)}$$

CFO_{it} : operating cash flow of company ***i*** at ***t*** periods.
Ait-1 : Total assets of company ***i*** at ***(t-1)*** periods
α0 : constanta
α1, β : regression coefficients
Sit : Total Sales of company ***i*** at ***t*** periods
ΔSit : Selisih penjualan perusahaan i periode t dengan penjualan periode t-1
E : Error

C. Types and sources of data

The data collection technique that will be carried out in this research is documentation. The data sources in this study are annual reports, financial reports, and sustainability reports which are downloaded through the IDX website and the official website of the company that is the object of research.

D. Research population and samples

The population in this study are non-financial companies and banks listed on the Jakarta Islamic Index from 2014 to 2021; a total of 54 companies. The sampling method in this study was carried out using the purposive sampling method. Based on the criteria that have been determined, the number of samples used is 288 samples that measured from 36 companies during eight financial periods.

E. Data Analysis Technique

This study used statistical inferential structural equation modeling (SEM) method using Analysis of Moment Structure (AMOS) software. It is intended that the results of data analysis in this study can be explained properly.

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IV. RESULTS AND DISCUSSION

A. *Overview of the research subject and object*

Research subjects used are all companies that listed in JII and also have published their financial statements and annual reports for 2014-2021 period at the IDX either compani's website. Companies sampled in this study have met the requirements specified previously (Table I).

B. *Identify the Headings*

The values of R^2 for each endogenous variable are presented in table II.

Hypotheses	Dependent Variables	R^2
H4	Financial Performance	0.0196
	Earning Management	0.0010

Table 1: Value of R^2

Source: Data processed result using PLS (2022)

For H4, variables of financial performance and earnings management each have a value of R^2 of 0.0196 and 0.001. It means that the financial performance variable can be explained 1.96 percent by the ISR variable and earning managements while the earnings management variable can be explained 0.1 percent by the ISR variable. While, table III showed the results hypotheses test using PLS.

H	Independent Variables	Dependent Variables	β value	*p* value	conclusion
H1	ISR	FP	0.033	0.3500	Rejected
H2		REM	0.066	0.6825	Rejected
H3	REM	FP	-0.0315	0.0018	Accepted

Table 2: Value of R^2

Source: Data processed result using PLS (2022)

The second part of the investigation (table II) concerns the correlation between ISR and financial performance, also ISR and earning management show that there is nothing statistically significant link. While the correlation between earning management and financial performance shows a negative and significant effect.

C. *Discussion*

a) The effect of ISR on financial performance
The results of the study showed that there was an insignificant positive relationship between corporate social responsibility practice and financial performance. Overall, companies tend to focus on CSR activities on employee welfare, community empowerment, and environmental conservation. While CSR those are targeted at products and customers is the least undertaken activity (Mwangi & Jerotich, 2013). Those are quite reasonable to explain the reason why the company's sales didn't increase when social responsibility disclosures have been increased significantly. This finding is in line with research conducted by Elouidani et al. (2015) and Walley & Whitehead (1994).

b) The effect of ISR on Real Earning Management
Islamic social reporting disclosure has positive effect on financial performance but did not significant. These findings are in line with research conducted by Wahyuno (2019), who found evidence that ISR didn't affect real earnings management through Cash flow operational. This proves that the management of companies listed in JII had no motivation to hide their opportunistic behavior behind the positive image of CSR. However, this result is not supported by the research of Dewi and Mahrani (2018) that found CSR has a positive effect on earning management. As well as research by Agatha et al. (2022), which states that CSR has a significant positive effect on earning management.

c) The effect of Real Earning Management on financial performance
This study found that earnings management has a negative significant effect on financial performance. When earnings management through CFO increased by one unit, leads to 0.0315 units decrease at subsequent first-year performance. CSR gives the impact of increasing the company's operating expenses so it could reduce the company's profit (Mahrani et al, 2018). In addition, social responsibility disclosures also increased the company's transparency. Therefore, an effort from management is needed to increase the company's profits without doing any opportunistic earnings management.

V. CONCLUSION

This study aimed to empirically examine how CSR performance affects corporate financial performance and whether the earning management has a mediating effect on the relationship between CSR and corporate financial performance. The results showed that CSR has a positive insignificant effect on financial performance and earnings management. Meanwhile, the results showed that earnings management has a negative significant effect on financial performance. But earnings management can partially mediate the effect of the CSR on financial performance.

This study only used one proxy for earning management variable and also the financial performance variable. It would be better if future research uses more than one proxies so it gave an obvious reflection of the correlation between research variables. Therefore, we suggest future research would add another variable that has not been included, uses another proxy, and also add a research time span.

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