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CSR and Earnings Management in India: Does Auditor's Opinion on Internal Control Matters?

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ABSTRACT

This study investigates Corporate Social Responsibility (CSR) and Earning Management (EM) relationship following the enactment of mandatory CSR reporting through Companies' Act, 2013 in India. Additionally, it investigates the moderating role of Internal Control Quality (ICQ) on the relationship between CSR and EM variables such as CSR have been measured through CSR Expenditures made by sample companies during the year while EM has been measured through two proxies Jones and Modified Jones model. Based on descriptive analysis, results report that average prescribed spending as per Companies Act 2013 criteria is higher and there is less actual spending from companies in 2015. However actual spending in 2016 is higher as compared to prescribed spending. Based on regression analysis, study shows that companies that have higher compliance with CSR activities have been found to be less engaged in EM. Additional analysis also reports that there is no positive relationship between CSR and EM. Thus, results report that CSR engagement has a negative influence on EM practices. These results inferred that companies in mandatory CSR environment tend not to use CSR activities for manipulating earnings irrespective of the presence of auditor opinion on internal control quality.

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1. Introduction

From last years, the topic of EM is under discussion and is also point of concentration for so many researchers, regulators, and practitioners. EM is a modification of reports of finance to mislead stakeholders about the companies financial results. Dechow and Skinner (2000) stated that EM will not constitute fraud if it has been used by managers under GAAP in order to adjust financial reportes. EM can be explained from two perspectives such as opportunistic perspective and signalling or informational perspective. Schipper (1989) argues, opportunistic perspective is used by managers with the aim of using discretionary accounting for their self-interest at the expense of company's stakeholders. But in the case of informational perspective, prospects of the companies are signalled by managers through using discretionary accruals.

Financial scandals around the globe such as the Asian financial crisis and accounting scandals in the USA questioned the governance system and transparency of firms as well as economies. Following the occurrence of these events, all stakeholders immediately required all firms to act responsibly. CSR contributes a dynamic part for every field which is linked with corporate governance, environmental effect, occupied situation, and influence to the financial expansion of companies.

In India, voluntary guidelines on CSR reporting were introduced in 2009 by the Ministry of Corporate Affairs which promised to ensure maximization of firm long run operations and also made their customers satisfied. These voluntary guidelines presented CSR activities as corporate philanthropy which can be dealt with based on compliance or explain approach. The voluntary guidelines have set the common standard for companies that these can use in order to improve their sustainability practices. In addition to this, these standards have created an expectation that companies will strive to meet these guidelines and those failing to comply will put themselves under pressure. These guidelines were applicable to all businesses irrespective of their location, sector, and size. These voluntary guidelines on CSR reporting remained to enact till the end of year 2011. However, in 2012, Companies Bill was proposed by the Government of India which among other things also included CSR related provisions. In 2013, this bill has been passed by the upper house of parliament for Central Public Sector Enterprises which has made CSR disclosures mandatory in India after succession of these voluntary guidelines. Kansal, Joshi, & Batra, (2014) explained that Companies Act, 2013 is a replacement to the Corporations Act, 1956 which explained that these CSR rules are applicable from the fiscal year 2014-15 onward.

Furthermore, Firms are encouraged to spend 2% of their profit of last three years on CSR initiatives. Furthermore, companies need to establish a separate CSR committee which must include an independent director. EM is about artificial structuring while CSR is about providing a true benefit to stakeholders and one can be achieved at the expense of others. In the modern world, these two perspectives such as EM and CSR are contradictory ones. Many researchers have shown in their studies that CSR has been greatly influenced by EM. From the beginning of this deliberation, positive or negative relationships have been shown.

In South Asia, India is first country where internal control quality regulations have been made mandatory through Companies Act 2013. The main reason for misleading financial reporting is that the law has not enforced guidelines as mandatory rules about auditor opinion whether it is included or not in the Auditors Report. For instance, Credit Lyonnais Securities Asia (CLSA) has examined that India's ranking slide from 3rd to 7th tremendously because of the financial scandal of Satyam computer Services. This law has been enforced for the avoidance of such manipulations in earnings which states that under Section 143 of Companies Act 2013, it is mandated for all companies to consider an auditor opinion whether company has adequate Internal Financial Control (IFC).

Reporting on IFC through auditor's opinion was voluntary for companies till the end of the year 31st march 2015 and it became mandated from and onward 1st April 2015. One of the main reasons for attaining Qualified Report is to measure ongoing concerns and problems in Financial Statements. Considering these mandatory guidelines, Section 143 of Company Act requires that the auditor should state in his report whether the company has effective internal control or non-effective. Hoitash, (2011) added an argument that as per Companies Act 2013, CEO & CFO certification has also been made mandatory for maintaining and evaluating internal control. This type of evaluation of internal controls is mandated quarterly and annually through financial statements. In clause 49, CEO/CFO certification had been mandated for all listed and unlisted companies to report about the effectiveness of their internal financial controls.

Previous literature on EM and CSR reporting shows that these are related to each other but there is inconclusive evidence on this relationship. Many studies such as (Alsaadi et al., 2017; García-Sánchez & García-Meca, 2017); Kothari et al. (2005) reported that more socially responsible companies engage less in EM practices. Whereas based on the studies such as Gargouri et al. (2010); (Muttakin et al., 2015; Scholtens & Kang, 2013), it has been found that companies with more engagement in EM are more prone to pursue CSR initiatives positively. Given this inconclusive evidence, there is a dire need to conduct more research in order to investigate how CSR reporting impacts EM. In addition given the Indian economy where CSR reporting has been made mandatory through Companies Act 2013, it would be more interesting to probe this issue in such a mandatory environment. Finally, there is also a need to investigate the moderating role of auditor opinion on internal control quality on this CSR and EM relationship when CEO/CFO certification regarding internal control quality is already in place through Company Act, 2013 and applicable from years 2014 and onwards.

The study contributes in a way that it is one of few studies which has been conducted in a mandatory CSR reporting environment in an emerging economy like India. The majority of studies on CSR and EM relationship have been conducted where CSR reporting is voluntary in nature. Further CSR reporting in this study has been measured directly from annual reports through CSR expenditures made by companies during a particular year as this approach to CSR measurement has also been adopted in a study conducted by Mukherjee et al. (2018). Finally, how auditor opinion on internal control quality affects CSR and EM relationship despite the fact that CEO/CFO opinion on internal control quality is already in place.

2. Literature Review

2.1 CSR & CSR Disclosure

CSR can be related to meeting economic, legal, and ethical responsibilities that stakeholders of society demand at a given point in time. According to Carroll (1979), highly socially responsible companies should make effort to earn profit, comply with the law. The strategic aspect of CSR is that companies need to maintain their relations with all stakeholders. So considering this, financial performance (Cho & Chun, 2016); Orlitzky et al. (2011); (Wang et al., 2015; Wang et al., 2018) and EM (Chih et al., 2008; Grougiou et al., 2014; Kim et al., 2012) are related with CSR. Financial integrity is expected to improve as a result of the disclosures, as well as the quality of the information provided to investors. CSR is commonly used to refer to non-financial disclosure. This argument has become even more relevant as a result of recent legislation in several countries requiring non-financial disclosure.

2.2 CSR, Earning Management & Internal Control Quality a Theoretical Perspective

Over the past few years, most of the research on CSR and EM relationship has reported two perspectives. According to the transparent financial reporting perspective, companies that behave in a highly socially responsible manner also tend to engage less in EM practices (Carroll, 1979; Jones, 1991; Kim et al., 2012). Further, Jones (1991) stated that companies with higher engagement in CSR are also motivated to be more honest, ethical and trustworthy. Companies that engage themselves more in CSR activities have an incentive to do the right things through restraining themselves from EM (Shleifer, 2004).

A study conducted by Kim et al. (2012) using a data sample of 57 countries found that companies with more CSR initiatives not involves in EM through discretionary accruals. Another study was conducted by Hickman & Jadiyappa (2021) using a sample of non-financial firms listed on the BSE. The effect of pre- and post-implementation of Companies Act 2013 was studied in India; the results reported that CSR activities decrease EM practices involvement after the implementation of the Act. Similar results have also been reported in studies conducted by (Alsaadi et al., 2017; Cho & Chun, 2016; García-Sánchez & García-Meca, 2017).

Contrary to this, opportunistic theory of financial reporting suggests a CSR and EM are positive related. Chih et al. (2008) stated that management might engage in EM practices through involving in higher CSR activities. This phenomenon will lead towards the creation of agency problem because managers might use CSR activities for their self-interest (Jensen & Meckling, 1976).

Considering the framework of signaling theory, it has been claimed that the relationship between CSR and EM will be negative. Sun et al. (2010) stated that the reporting of CSR related information to investors and financial markets will signal that the company is able to manage all its risks including social risks. Further, the disclosure of CSR related information to the market participants will reduce information asymmetry among them (Grougiou et al., 2014). This is the reason while for this theory to assume a negative relationship between CSR and EM because this usually prevails in case of high information asymmetry. So, this theory claims that companies with higher commitment to CSR engagement will strive to achieve long-term relationship with stakeholders. Oussii & Taktak (2018) conducted a study by gathering data from 59 chief audit executives based in Tunisian companies and reported that internal control quality is positively associated with audit quality and audit function competence. Consequently, Improved audit quality can help in reducing the opacity of reporting and it reduces the accrual-based EM. (Becker et al. 1998; Johnson et al. 2002; Balsam et al. 2003; Ball 2009).

2.7 Hypothesis of the Study

So based on this contradictory evidence as well as theoretical conflict in previous literature, the research hypothesis is developed as follows:

H1: There is an impact of CSR disclosure practices on EM.

H2: ICQ moderates the relationship between CSR disclosure practices and EM

3.0 Methodology of the study

This study used a sample of the top BSE 500 index. These companies used to represent more than 90% of market capitalization on BSE, and they were also a suitable representation of all sectors of the Indian economy. These firms' annual reports for the years 2015 and 2016 served as the source for the data pertaining to all of the variables of interest, and those reports were collected. The reason for selecting these two years is that on February 27, 2014, India's Ministry of Corporate Affairs approved the Indian Companies Act of 2013's final regulatory requirements (Dharmapala and Khanna 2018). The Act went into effect on March 31, 2015, at the end of the fiscal year.

Out of the total 500 samples, companies relating to the financial sector have been dropped from the analysis due to their unique nature of the operation. In addition to this, annual reports relating to some sample companies were not available on their websites and also some issues relating to missing data in annual reports were to be found. As a result, this has left with us a final sample of 325 sample companies for analysis.

The following two econometric models have been used in this study which is supported through hypothesis.

$$EM_{it} = \beta_0 + \beta_1 CSR_{it} + \beta_2 ROA_{it} + \beta_3 LEV_{it} + \beta_4 SIZE_{it} + \beta_5 MB_{it} + \varepsilon_{it} \text{..... (Eq. 1)}$$

Where EM_{it} is the EM measured through discretionary accruals using Jones and Modified Jones models of firm i in year t; β_0 represents the constant; β_1 represents the effect of CSR expenditures made by firm i in year t on EM behaviors; β_2 to β_5 represents the effects on EM relating to control variables of the study. Equation 1 study the impact of mandatory CSR spending by sample companies on their behavior to engage in EM practices.

$$EM_{it} = \beta_0 + \beta_1 CSR_{it} + \beta_2 ICQ_{it} + \beta_3 ICQ_{it} * CSR_{it} + \beta_4 ROA_{it} + \beta_5 LEV_{it} + \beta_6 SIZE_{it} + \beta_7 MB_{it} + \varepsilon_{it} \text{...(Eq. 2)}$$

In equation 2, moderating role of auditor opinion on Internal Control System (ICS) on relationship between mandatory spending on CSR and EM has been studied.

4.0 Results

4.1 Descriptive statistics

Table I reports that the mean value of EM based on calculation of Jones Model is -0.02 in 2015 followed by -0.036 in 2016 which is quite low. The minimum and maximum values range from -0.688 to about 0.387 which has not been reflecting substantial variations. Almost similar results have been found in respect of the Modified Jones model as well. Finally, the results regarding CSR expenditures that are based on descriptive statistics show that companies have spent on average lesser amount on CSR activities in 2015 as compared to the average required spending calculated as per criteria laid down in CSR mandatory guidelines in Companies Act 2013. However, in 2016, sample companies have spent on average higher amount on CSR activities as compared to average required spending. The main reason for this result is that sample companies have left some unspent portion of CSR budget in 2015 and carry forwarded it for spending in subsequent years.

Considering the results regarding pair wise correlation coefficients, Table III reports that explanatory variables such as CSR and Auditor's Opinion on Internal Control Quality (ICQ) including control variables have hypothesized relationship with the dependent variable e.g. EM. Most importantly, it has been found that CSR significantly related to both proxies of EM.

Table 1: Descriptive Analysis

	Mean		**Minimum**		**Maximum**		**Std. Dev**	
	2015	**2016**	**2015**	**2016**	**2015**	**2016**	**2015**	**2016**
EM_Jones	-0.02	-0.036	-0.688	-0.688	0.387	0.387	0.138	0.147
EM_MJones	-0.031	-0.037	-0.869	-0.869	0.363	0.363	0.16	0.161
CSR_RSpending	15.07	17.10	0	0	285	360	39.676	45.668
CSR_ASpending	14.37	18.50	0	0	285	492	37.637	52.205

4.2 Multiple regression analysis

4.2.1 Effect of CSR on Earnings Management

To test the first hypothesis representing in equation 1, multiple regression analysis has been performed using data related to all variables of study as reported in Table IV. Before running the regression model, VIF test is performed and its value lies within range thus indication of no multicollinearity exists in the data. As reported earlier that EM in this study has been calculated by using two models e.g., Jones and Modified Jones model, so the results of all regression analysis have been performed and reported as models 1 & 2 respectively. Model 1 of this table reports that CSR expenditures made by sample companies during 2015 & 2016 have a highly significant negative effect on EM behavior (β = -0.002; p-value=0.008). Thus, the sample companies which used to made CSR expenditures on different CSR activities during the year in India are less engaged in EM activities. Results relating to all control variables as reported in the model 1 of this table also confirm with the previous literature.

A similar negative impact of CSR spending on EM behaviour of sample businesses was discovered at the 1% level of significance (= -0.002; p-value=0.005), as shown in model 2. These findings suggest that corporations in India, where CSR participation is mandated, do not often utilize it as cover for engaging in profit management tactics.

Table II Pair wise correlation and variance inflation factor of all variables

Variables	CSR_Spend	Firm_size	MB_ratio	Lev	ROA	EM_Jones	EM_MJones	VIF
CSR_Spend	1.000							1.01
Firm_size	0.561***	1.000						1.12
MB_ratio	0.111**	0.162***	1.000					1.03
Lev	-0.104**	0.107***	-0.002	1.000				1.12
ROA	0.121***	-0.312***	-0.123***	-0.3***	1.000			1.23
EM_Jones	-0.237***	0.480***	0.065	-0.019	-0.001	1.000		
EM_MJones	-0.19***	0.438***	0.079*	0.025	-0.039	0.865***	1.000	

** p<0.05; *** p<0.01

Table III The relationship between CSR and Earnings Management

Variable	(EM_JONES) Model 1	(EM_MJONES) Model 2
CSR_ASPEND	-0.002	-0.002
	(2.67)**	(2.82)**
Firm size	0.13	0.13
	(12.64)**	(10.85)**
MB_RATIO	-4.78	12.17
	(0.13)	(0.27)
Lev	0.002	0.006
	(0.25)	(0.84)
ROA	0.449	0.415
	(6.54)**	(5.20)**
R^2	0.265	0.20
N	501	500

This table reports the results of Regression Analysis by using two different proxies of EM such as EM_JONES (Model 1) and EM_MJONES (Model 2). The CSR has been measured through Prescribed and Actual spending of companies.

4.2.2 Effect of Internal Control Quality on the relationship between CSR and Earnings Management

For testing hypothesis 2 of this study which has been represented as equation 2 in the above section, results relating to that hypothesis have been reported in model 1 & 2 of Table V respectively same as the previous table. However, in this table, moderating effect of internal control quality on the relationship between CSR expenditures and EM has been investigated. As stated in the previous section, internal control quality in this study has been measured through the auditor's opinion on the effectiveness of the ICS which was applicable for years 2016 and onwards. We performed moderation through internal control quality variable along with interaction term between internal control quality and CSR expenditures. Results reported in model 1 of Table V describe that again CSR expenditures have a negative effect on EM behavior of sample companies at 1% level of significance (β = -0.002; p-value=0.007). However, the moderating effect of internal control quality on the relationship between CSR expenditures and EM has not been found significant. These results infer that the auditor's opinion on internal control quality does not matter irrespective of the fact that this provision has been made mandatory in India through the enactment of Companies Act, 2013. When we repeated this analysis in model 2 of the table, similar results have been found which confirm the consistency of our analysis.

Table IV The relationship between CSR and Earnings Management: Does Auditor's opinion on Internal Control Quality matter?

Variable	(EM_JONES) Model 1	(EM_MJONES) Model 2
CSR_ASPEND	-0.002	-0.002
	(2.69)**	(2.50)**
Firm_size	0.131	0.131
	(12.70)**	(1.86)**
MB_RATIO	-4.453	12.41
	(0.908)	(0.28)
Lev	0.002	0.006
	(0.26)	(0.85)
ROA	0.445	0.419
	(6.62)**	(5.24)**
AO_ICS	-0.02	-0.014
	(1.64)	(0.93)
CSRAO_ICS	0.001	0.001
	(0.96)	(0.49)
R2	0.275	0.205
N	501	500

4.2.3 Additional Analysis

In order to improve the validity of our results, additional analysis has been performed by creating new variables such as CSR Spending Level (CSR_SLEVEL) through two proxies of EM. The higher level of spending is expressed by "1" and the Lower level of spending is expressed by "0". Again, in both models of Table VI as stated below, similar results have been found however at an insignificant level e.g., Furthermore, the analysis has also been performed separately for positive discretionary accruals and negative discretionary accruals. Results have been found again to have negative effect of CSR expenditures on EM behavior of sample companies in a mandatory CSR environment in India.

Table V Additional analysis of the relationship between CSR and Earnings Management

Variable	(EM_JONES) Model 1	(EM_MJONES) Model 2
CSR_SLEVEL	-0.015	-0.003
	-0.7	-0.11
Firm_size	0.161	0.153

	(10.75) **	(9.16) **
	-1.503	2.202
MB_RATIO		
	-0.13	-0.17
	0.002	0.003
Lev		
	-0.13	-1.13
	0.4	0.394
ROA		
	(3.75) **	(3.31) **
	-0.02	-0.011
AO_ICS		
	-1.11	-0.57
	0	0
CSRAO_ICS		
	-0.76	-1.14
R^2	0.2	0.16
N	499	498

5. Summary and conclusion

The primary objective of this study is to investigate how CSR reporting in a mandatory environment in a developing country. This CSR reporting was made mandatory in 2013 through the enactment of Companies Act, 2013. In addition to this, Act has made it mandatory for CEO/CFO of listed companies to make a statement regarding the effectiveness of the ICS of company. Further, this Act has made it compulsory for external auditors of these companies to make an opinion on the effectiveness of the ICS. So, this study has further investigated that whether this auditor's opinion on ICS assessment matters to the relationship between CSR reporting and EM behavior in addition to CEO/CFO certification on ICS assessment.

Based on the descriptive analysis of BSE 500 index companies for the years 2015 & 2016, it has been reported that there is gradual improvement in the level of average CSR spending on different CSR activities over two years period. Further results of regression analysis report that CSR expenditures made by sample companies on different CSR activities have a significant negative effect on the behavior to engage in EM. These results have been found consistent using different proxies of EM (including positive discretionary versus negative discretionary accruals) and also categorizing the CSR spending into high level spending and low-level spending. Finally, this relationship exists irrespective of the fact whether auditor opinion on ICS has been made at the end of the year.

This study has contributed to the literature as follows. First India is one of the very few countries in the world and only country in Asia which has made it mandatory for a certain class of listed companies to make CSR expenditures. Previous literature on the CSR and EM relationship has been found as having mixed evidence and no notable study has investigated this phenomenon in an emerging developing economy like India. Therefore, this study contributes significantly towards the literature in a way that it has been conducted in a mandatory CSR environment. Secondly, findings of the study help us to support this proposition that mandatory environment on CSR reporting in an emerging developing economy cannot be used as a shield to engage in EM practices. Thus, these results show the effectiveness of CSR reporting regulations in an emerging developing country.

Considering the implications of this study, mandatory reporting on CSR spending has decreased opportunities for companies involved in voluntary CSR spending and used that as a window to manipulate earnings. By introducing this mandatory CSR reporting through the Companies Act, 2013, every company which meets the CSR spending criteria will be required to make spending on CSR activities. Secondly irrespective of the auditor opinion on the effectiveness of the ICS, CSR spending does not motivate companies in India to engage in EM practices. Thus, in this sense, it is important to question the effectiveness of auditor opinion on ICS in the presence of CEO/CFO opinion on the ICS.

Likewise other studies, the study has limitations. The first one is related to the fact that this study used data from only non-financial sector companies which are based in single country like India. Second other governance factors have not been considered as moderator in this study. Future research can be conducted using data related to other governance variables such as ownership concentration as moderator to investigate this relationship between CSR spending and EM. Moreover, it would be quite interesting to reinvestigate this in the financial sector companies. This research has significant practical implications. Our findings are particularly beneficial because they allow managers to leverage a better understanding of the relationship between CSR and EM to influence their strategies for and execution and maintenance of initiatives aimed at improving both variables.

Authors Contribution

Khurram Ashfaq: Conceived the presented idea and developed the theory
literature search, study design, drafting and data analysis
Adil Riaz: Literature search, data collection,
Saffa Maqsood: Methodology, proofreading and editing

Conflict of Interests/Disclosures

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