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CORPORATE SOCIAL RESPONSIBILITY AS AN ENTRENCHMENT STRATEGY: MALAYSIA EVIDENCE

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Abstract

Fundamentally, companies utilize sustainability as a device to give the impression of legitimacy and satisfy their stakeholders' demand in relation to the socially responsible activities. However, this conventional employment of sustainability has been compromised by companies in several countries. This study analyse the association between earnings management and corporate social responsibility (CSR). With the basis of stakeholder-agency theory, CSR seems to be revolutionized as a hedging mechanism by the managers that practice earnings management. This study aims to demonstrate the misuse of CSR as an entrenchment strategy to mask earnings management practices. Using the Modified Jones Model discretionary accruals to measure earnings management and content analysis by CSR disclosure index to determine the level of CSR quality disclosure on a sample of 265 Malaysian public listed companies, the findings report no significant statistical association between earnings management and CSR which suggests that Malaysian managers do not exploit socially responsible activities for their own interest particularly to entrench themselves. Additionally, it indicates that CSR has been exercised by Malaysian companies truthfully and accountably for their shareholders and stakeholders. Moreover, the moderator of corporate reputation influences the respective relationship. This study provides several implications. Theoretically, research on the notion of CSR serving as the entrenchment mechanism seems limited in developing countries. Practically, this study suggests that investors and practitioners exercise caution when assessing the CSR practices since it can be carried out to mislead the stakeholders.

Keywords: Earnings management, corporate social responsibility, entrenchment strategy, stakeholder-agency theory, corporate reputation.

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1. Introduction

Companies regard corporate social responsibility (CSR) as a device that facilitates them in giving optimum return to the society and serves as an effective mechanism to satisfy the stakeholders' expectation. Similarly, CSR helps to improve a company's financial performance, image and reputation along with competitive advantage and value (Albuquerque, Koskinen, & Zhang, 2017; Kahreh, Babania, Tive, & Mehdi, 2014). With regards to those advantages of CSR, Malaysia promotes and encourages companies to be more socially responsible by issuing several incentives. In a more recent event, the latest Companies Act 2016 has introduced in Part II of the 5th Schedule to optionally include a Business Review as part of the contents in the Directors' Report whereby companies are encouraged to report information about environmental matters, company's employees and any social and community issues (Suruhanjaya Syarikat Malaysia, 2016).

Unfortunately, of late, researchers and academicians argued that CSR can be used in multiple formations. Contrary to the concept from prevalent theories of legitimacy theory and stakeholder theory, prior studies have been highlighting the association between earnings management and CSR. Basically, earnings management has been known as the mechanism that negatively influences financial performance (Ching, Teh, San, & Hoe, 2015; Gill, Biger, Mand, & Mathur, 2013), value relevance (Mostafa, 2017; Shan, 2015) and reputation (Martínez-Ferrero, Rodriguez-Ariza Manuel, & Bermejo-Sánchez, 2016). Based on those detrimental effects, companies tend to search for a technique and in accordance with stakeholder theory and legitimacy theory, prior studies reported that CSR could fix and ameliorate the affliction caused by earnings management.

Differently, irrational managers practice CSR by way of misusing it to reinforce the entrenchment strategy (Cespa & Cestone, 2007; Martinez-Ferrero et al., 2016; Prior, Surroca, & Tribó, 2008; Surroca & Tribo, 2008). According to stakeholder-agency theory proposed by Hill and Jones (1992), this strategic approach is proven as being misused by the irrational managers in developed countries. The notion behind this approach is that, this opportunistic motivation is deliberately conducted by irrational managers to deceive the stakeholder from detecting their opportunistic managerial discretion, gain the stakeholders' support and receive favourable media coverage (Cespa & Cestone, 2007; Choi, Lee, & Park, 2013; Martinez-Ferrero et al., 2016; Prior et al., 2008).

2. Problem Statement

Grounded with the benefits of CSR (such as improved performance and reputation), companies are contending amongst themselves to appear as socially and environmentally responsible companies. However, researchers are alarmed with the issue of misuse of CSR against earnings management that serves as the managerial entrenchment despite the morality brought by CSR. Underpinned with agency problem, irrational managers involved in earnings management may opt for overinvestment in socially responsible concessions, namely CSR by way of a hedging strategy against any disciplinary actions (Prior et al., 2008; Surroca & Tribo, 2008) and unfavourable media coverage (Cespa & Cestone, 2007). Managers resort to more CSR engagements as this way may satisfy their stakeholders' demand and expectation which could appease the negative reactions to the perceived earnings management that

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resulted from the agency conflict of interest. CSR can be promoted as a means of building trust and cooperative relationships with stakeholders who manage and control key resources that hold the longevity of a company (Prior et al., 2008), allow managers to reinforce their job security (Shleifer & Vishny, 1989), protect from costly media boycotts and stakeholders activism since the stakeholders' demand have been satisfied with social and environmental concessions (Cespa & Cestone, 2007).

Previous studies in relation to examining the association between earnings management and CSR have been performed mostly in the developed countries and the results are mixed. Building upon this issue, this study invests a potential moderating variable; namely corporate reputation. Both poor and good reputable companies practice numerous CSR activities as it is deemed to be an important device to fix poor reputation (Guillamón-Saorín, Guiral, & Blanco, 2017) and sustain good reputation (Kansal, Joshi, & Batra 2014). Additionally, the existence of discretionary accounting practices negatively affects corporate reputation (Martinez-Ferrero et al., 2016). Implying these argument, corporate reputation could moderate the relationship between earnings management and CSR in the notion that companies that involved in earnings management may further increase their practice in socially responsible activities due to the harmful effect on their reputation. Hence, corporate reputation can be a factor of moderation by strengthening the relationship between earnings management and CSR.

3. Research Questions

This study examines the effect of earnings management on CSR. The following are the research objectives:

- Is earnings management associated with CSR?
- Does corporate reputation moderate the relationship between earnings management and CSR?

4. Purpose of the Study

Due to the limited studies in examining the effect of earnings management on CSR, this study wishes to add empirical findings for this realm especially for the developing countries. Different findings may be derived due to the different avenue and setting in Malaysia. Additionally, incorporating corporate reputation as moderating variable has been taken into account since it appears to have the ability to strengthen the respective relationship.

5. Research Methods

5.1. Earnings Management and CSR

The association between earnings management and CSR could be enlightened by stakeholder-agency theory. As proposed by Hill and Jones (1992), although both theories seem fairly unrelated in history along with the focus, scholars unified both theories as they appear to complement each other. Both theories examine the conflicts and associations amongst interest groups, being either principals versus agents (agency theory) or the company in its broader societal context (stakeholder theory). Concerning the managers, other than the shareholders, they may need to discharge their role as trustworthy agents to

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the stakeholders (who in turn act as their principals). Further, managers possess a unique role as they can be seen as the agents of different level of stakeholders, namely shareholders, creditors, employees, suppliers, customers, local communities and society. Any decisions or actions made by the managers shall also affect the non-shareholders stakeholders as their roles are not only the agent for the shareholders, but also serve as the stakeholders' agents (Hill & Jones, 1992; Prior et al., 2008).

Principally, misalignment of interest between managers and shareholders that initiates the former to pursue their interest at the expense of the latter (known as agency conflict), leads managers to seek for strategy that could defuse the disciplinary mechanism of the capital market in order to preserve corporate control (Jensen & Ruback, 1983). In the context of managing the conflict of interest, irrational managers strategically choose overinvestment as the entrenchment mechanism (Pawlina & Renneboog, 2005). Hence, incorporating CSR into the perspective, managers may increase financial resources allocated to CSR which in turn could serves as the hedging strategy against any disciplinary action charged by the discontented and affected parties (Choi et al., 2013; Prior et al., 2008; Surroca & Tribo, 2008). Additionally, Cespa and Cestone (2007) suggest that CSR can be used as the managerial entrenchment mechanism by way of satisfying the stakeholders' demand on socially responsible activities. The notion is that the incumbent managers (who are involved in managing earnings) who may be under pressure to be replaced may make manager-specific investments by adopting CSR activities strategically as an entrenchment strategy that will later turn to stakeholder-friendly projects and buy off the stakeholders. The relationships formed between incumbent managers and stakeholders could be augmented to a powerful entrenchment strategy especially in those countries that have strong political lobbying, social activism and media campaigns since stakeholders are deemed to hold substantial effective control on companies.

Interestingly, the researchers emphasized on the power of media and politician since they could initiate boycotts that could pose a threat of harm to the incumbent managers. Therefore, managers strive to convince and please the aforementioned stakeholders to strengthen their entrenchment strategy and hide their poor financial performance and managers' managerial opportunism (Choi et al., 2013). Accordingly, knowing that CSR activities deliver favourable media coverage to the managers and thereby provide the impression of responsible global citizens (Cahan, Chen, Chen, & Nguyen, 2015; Jo & Harjoto, 2011), irrational managers will then have special motives for engaging themselves more in socially responsible activities as this could lead to closer relationships with the stakeholders who eventually deliver to them the stakeholders' support and protection as well as positive media coverage as a way to validate their action. Therefore, this motivation leads to positive relationship for the respective relationship as reported in previous research (Choi et al., 2013; Martinez-Ferrero et al., 2016; Prior et al., 2008; Surroca & Tribo, 2008).

On the other hand, previous studies reported negative relationship with the basis of legitimacy theory and stakeholder theory whereby companies with high earnings quality, that is lower earnings management, have greater CSR practicing Alsaadi, Jaafar, & Ebrahim, 2013; Kim, Park, & Wier, 2012; Scholtens & Kang, 2012). This negative relationship presents transparent and reliable financial reporting quality. By the same token, managers that are not in motivation to manage earnings may give more attention to issues that are relevant to their stakeholders. Hence, it is a normal obligation for them. On the

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other side of the coin, this notion is also closely related to social norms whereby those managers that actively manage earnings have not internalized the endorsed norms associated with CSR thus, abandon their involvement in CSR or even demonstrate indifferent and unconcerned attitude towards it (Grougiou, Leventis, Dedoulis, & Owusu-ansa, 2014). Similarly, those irrational managers will not be motivated with social commitment and practice lesser CSR practices since their fundamental concern is to manipulate earnings (Martinez-Ferrero, Gallego-Alvarez, & Garcia-Sanchez, 2015).

However, this study adheres to the conception of CSR as the hedging strategy based on stakeholder-agency theory whereby it has been revolutionized by the irrational managers to reinforce their entrenchment.

H_1: Earnings management is positively associated with corporate social responsibility

5.2. The Moderating Role of Corporate Reputation

The second aspect of this research is in relation to the ability of corporate reputation (CR) in triggering the relationship between earnings management and CSR. Reputation can be considered a device that indicate a company's perceived capacity in accommodating stakeholders' demand (Waddock, 2000) and crucial for its potential of value creation and difficulty of imitating its intangible character (Roberts & Dowling, 2002). As such, a successful CR has the power of increasing a company's financial performance as well as the ability to sustain superior profits over time.

One of the devices that could facilitate companies to reach supreme reputation or fix poor reputation is by engaging in socially responsible activities. Correspond to stakeholder theory and legitimacy theory, demand made by stakeholders concerning to CSR are satisfied and thus, influence public perceptions and diligently involve in CSR could legitimized their actions (Abu Bakar & Ameer, 2010; Saleh, Zulkifli, & Muhamad, 2010) by which protect and enhance the company's reputation and image. Reputable companies tend to make greater CSR disclosure in order to maintain their CSR image and society is most likely to pay more attention and pressure over these companies (Kansal et al., 2014). Similarly, poorly reputed companies practice and report CSR practices to enhance their image and improve their reputation (Guillamón-Saorín et al., 2017).

Furthermore, the consequence of earnings management is beyond doubt detrimental and Martinez-Martinez-Ferrero, Rodriguez-Ariza, and Garcia-Sanchez (2016) found that it led to loss of reputation and support among shareholders and other stakeholders. Implying its moderating role, CR magnifies the said relationship with the notion that companies involved in earnings management shall deepen their engagement in CSR practices in order to sustain or protect their reputation.

H_2: Corporate reputation moderates the relationship between earnings management and corporate social responsibility

With regards to the hypotheses discussed above, those hypotheses can be achieved through the research method as illustrated as follows.

The sampling frame of this study is the year 2016 of PLCs Bursa Malaysia main board. Stratified random sampling is found to be the most relevant sampling technique for this study to attain the sample population that best represents the entire studied population. In the year 2016, there were a total of 806 companies listed on the main board (prior to excluding the financial Sector, PN17 companies and GN3

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companies). 265 companies were selected for year 2016 and this number of samples can be considered as appropriate given that the size of population required by Krejcie and Morgan (1970) is a sample size of 260 and more than the sample size suggested by the statistical power analysis of G*Power 3.1.2 Faul, Erdfelder, Buchner, & Lang, 2009). Classified into 9 types of sectors (after excluding finance and REITS), industries with fewer than eight companies were excluded from the analysis (Davidson, Goodwin-Stewart, & Kent, 2005). Hence, the industries of Hotel and Mining are eliminated.

5.3. Measurement of Variables

5.3.1. Independent Variable and Control Variables

To gauge the level of earnings management, it will be computed using the Modified Jones model due to its superior specification. Dechow, Sloan, and Sweeney, (1995) introduced the Modified Jones model, which has become one of the most widely-used models in earnings management research to compute discretionary accruals which is the proxy for earnings management in this study. The level of discretionary accruals is calculated as the difference derived from the company's total accruals and it non-discretionary accruals (NDAC) which can be computed as the following equation:

$$NDACi,t/Ai,t\text{-}1 = \alpha_1(1/TAi,t\text{-}1) + \alpha_2(\Delta SALESi,t, - \Delta RECi,t\ t/TAi,t\text{-}1) + \alpha_3(PPEi,t/TAi,t\text{-}1) + \varepsilon$$

Where $NDAC_t$ is non-discretionary accruals, TA_{t-1} is total assets, $\Delta SALES_t$ is the change in sales, ΔREC_t represents accounts receivable, *PPEt* represents the PPE of company and ε is the error term.

To estimate total accruals, this study uses the cash-flow approach whereby it involves deducting the cash flow from operations obtained from the statement of cash flows from the amount of net income from the income statement. Following previous studies, control variables of company size (FSIZE) and leverage (LEV) (Choi, Lee, & Park, 2013; Prior et al., 2008) and profitability (ROA) (Haniffa & Cooke, 2005) are included in the model to control their possible impact on earnings management. *FSIZE* is measured by the natural logarithm of total assets, LEV is measured as ratio of total liabilities to total assets and ROA is calculated as net income divided by the total assets at the beginning of the year.

5.3.2. Dependent Variable

CSR is examined using a disclosure index developed from previous studies (Anas, Majdi, Rashid, & Annuar, 2015; Haji & Ghazali, 2013; Sadou, Alom, & Laluddin 2017; Saleh et al., 2010). In particular, the quality of CSR uses a score of 3 if the disclosure encompasses monetary information, score of 2 if specific CSR information is disclosed, score of 1 for general information and score of 0 for no disclosure.

5.3.3. Moderating Variable

Corporate reputation (CR) is measured using a corporate reputation index constructed from previous studies (Darus, Othman, & Arshad, 2014; Othman, Darus, & Arshad, 2011) whereby a company is awarded a score of '1' if the item in the reputation disclosure checklist is reported in its annual report and "0" if otherwise.

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5.4. Discretionary Accruals Model Specification

Two empirical models are as follows:

$CSR = \beta_0 + \beta_1 DACC + \beta_2 FSIZE + \beta_3 LEV + \beta_4 ROA + \varepsilon_{it}$

$CSR = \beta_0 + \beta_1 DACC*CR + \beta_2 FSIZE + \beta_3 LEV + \beta_4 ROA + \varepsilon_{it}$

Where, DACC is discretionary accruals; CSR is corporate social responsibility disclosure score; CR is corporate reputation score; FSIZE is company size; LEV is leverage; ROA is profitability.

Prior to settling into choosing the right regression model, this study has performed several tests to ensure the assumptions were met. This study data violated one of the assumptions and deemed to have heteroscedasticity issue confirmed by the Breusch-Pagan test. To resolve the problem of heteroscedasticity, Wooldridge (2006) proposes weighted least square (WLS) regression method correction of heteroscedastic data. Further test determined that leverage (LEV) has caused the data to exhibit heteroscedasticity and will be use as the weight. Hence, this study employs WLS to regress the respective multiple regression equation (Table 01).

6. Findings

Table 01. Descriptive statistics

Particular	Min	Max	Median	Mean	Std. Deviation
Independent Variable					
Absolute value discretionary accruals (DACC)	0.001	0.335	0.037	0.057	0.060
Dependent variables					
Corporate social responsibility (CSR)	0.067	0.792	0.292	0.322	0.126
Control variables					
Company size (FSIZE)	3.916	8.290	5.663	5.752	0.677
Leverage (LEV)	0.000	6.657	0.153	0.705	1.299
Return on assets (ROA)	-11.182	3.883	0.020	0.021	0.776
Moderating variable					
Corporate reputation (CR)	0.25	0.938	0.563	0.569	0.143

Table 01 records that *DACC,* the mean value of discretionary accruals for this study is relatively small, amounting to 0.057. The result reported the discretionary accruals average value in Malaysia is 5.7 percent, which is consistent with previous research among Malaysian companies (Bamahros & Wan Hussin, 2015; Selahudin et al., 2014). CSR scores with the mean of 32.20 percent. The result reported disappointing figures since the quality of CSR disclosures is low whereby the average scoring of quality CSR disclosure barely reached half of the maximum score though it shows an increment as compared to previous study (Abdifatah, 2013). The average level of *FSIZE* is 5.752, *LEV* is 0.705 and *ROA* is 0.021.

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Table 02. Correlation matrix

	CSR	**DACC**	**CR**	**ROA**	**FSIZE**	**LEV**
CSR	1					
DACC	-0.078	1				
CR	.530**	-0.097	1			
ROA	0.046	-0.07	0.091	1		
FSIZE	0.608**	-.160**	.338**	0.005	1	
LEV	0.305**	-0.12	0.05	-.170**	0.442**	1

**. Correlation is significant at the 0.01 level (2-tailed).

Table 02 displays the correlation matrix between designated variables. CSR significantly correlates with several variables, such as the CR and FSIZE. These findings suggest that companies with higher reputations tend to practice and report greater levels of CSR to communicate, disseminate and give the impression of legitimacy to their stakeholders. Further, larger companies project socially responsible behaviour as they received more public scrutiny and attention compared to the smaller ones.

Table 03. Regression results: Relation between earnings management and CSR and moderating variable of corporate reputation

Variables	**Predicted Sign**	**Coefficient**	**t-statistics**
(Constant)		-52.277	-9.872
Independent Variable			
DACC	+	-95.506	-1.234
Moderating Variable			
CR	+	29.254	4.088***
DACC X CR	±	8.668	1.090
Control variables			
ROA	+	0.594	1.936***
FSIZE	+	13.278	16.377***
Adjusted R^2	0.741		
F-value	147.951***		
N	265		

Table 03 reports the results for both empirical models. Contrary to hypothesis H_1, the association between earnings management and CSR appears to be insignificant with negative relationship, therefore rejecting the hypothesis. The finding suggests that PLCs in Malaysia did not misuse CSR as an entrenchment mechanism and practicing CSR for the sake of legitimacy and satisfy the stakeholders' demand which is consistent with prior studies (Alsaadi et al., 2013; Kim et al., 2012; Scholtens & Kang, 2012). Corresponding to CR as moderator and hypothesis H_2, the result shows that it has the ability to change the behaviour of the relationship yet not to the extent of making the relationship significant. The moderator of CR changes the direction of the respective relationship from a negative to a positive relationship. The possible reasons behind the change in direction is that it could possibly due to the significant at 1% relation and correlation between CR and CSR which indicates that CR could be a variable that strongly influence CSR which suggest that both high and low reputation companies strive to produce more CSR activities as reputation is highly important to a company.

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7. Conclusion

Empirical findings have been derived with regards to CSR being misused to reinforce entrenchment strategy for developing country, Malaysia. The findings also add the knowledge on corporate reputation (CR) as the moderating effect for the said relationship. This study suggests investors to assess diligently on the financial statements should there is any discrepancy in financial reporting despite relatively low level of discretionary accruals reported in Malaysia PLCs. Further, the quality of CSR is also reported at a low level. Hence, this study calls for the regulators to continue and improve their initiatives in encouraging the companies to focus more on providing quality disclosures instead of only emphasizing the quantity of disclosure. Additionally, CR has changed the direction of relationship between earnings management and CSR. Hence, CR can be classified as a variable that is substantial and could to be experimented further.

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