Does Mandatory CSR Legislation Facilitate Earnings Management? Evidence from India

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Abstract*: This study examines the association between mandatory corporate social responsibility (CSR) and earnings management. The Government of India mandated all industries to spend and disclose CSR through the Indian Companies Act 2013 with effect from financial year 2014. Management has an incentive to manage reported earnings and avoid fluctuations in reported income as investors prefer firms reporting steady growth in income. We use panel data from a sample of 80 Indian non-financial companies over the period 2014 to 2017. We investigate the possibility of using unspent CSR funds for earnings management. Earnings management calculated using the coefficient of variation method is regressed against unspent CSR and control variables such as Size, Market to Book (MB), Return on Assets (ROA) and Leverage (LEV) to evaluate the effect of unspent CSR on earnings management. We expect a positive association between unspent (carried forward) CSR funds and earnings management. Our findings indicate that companies may use unspent CSR funds to manage reported earnings. This study provides evidence to policymakers and enforcement authorities that mandating CSR spending could have unintended consequences such as facilitating earnings management and thus impeding the financial transparency.

***Index Terms*: Corporate Social Responsibility, Earnings Management, Income smoothing, Unspent CSR.**

I. INTRODUCTION

Corporate Social Responsibility (CSR) acts as an instrument that integrates social, human and environmental concerns into the corporate value chain according to Dahlsrud and Alexander [1]. CSR addresses various complex issues such as employee and worker health and safety, supplier-customer relationships, as well as environmental protection and community relationships. It improves the company's reputation, the confidence of different stakeholders in the company as well as leads to a reduction in the company's financial risk according to Prior [2]. The Government of India introduced mandatory CSR through the Companies Act 2013 and specified criteria to identify companies obliged to comply with the mandate. India is the only country to have mandated all industries to spend and disclose CSR.

Healy and Wahlen [3] define earnings management as a mechanism used by insiders to mislead different stakeholders or influence implicit and explicit contracts by altering the real value of transactions and thus the reported performance of the companies. Managers may smooth income to ensure job security, external financing or compliance requirements. Disguising the actual value of transactions, the value of the assets of companies or the financial position may have a detrimental effect on the relevance of earnings value, share returns and the reputation of firms [4]. Previous research documents mixed results regarding the relationship between CSR and earnings management. This paper studies the relationship between mandatory CSR and earnings management using a sample of panel data from 80 Indian non-financial firms between 2014 and 2017. We expect to find a positive association between unspent (carried forward) CSR funds and earnings management. We use hierarchical multiple regression analysis to investigate the possibility of using unspent CSR funds for earnings management.

The study is organized as follows. We review previous studies in the next section and develop our hypothesis. A section that presents the methodology and the design of the research is followed. In the section Data Analysis and Interpretation, we describe the analysis of the results and the study ends with the main conclusions in the section Conclusion.

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II. LITERATURE REVIEW AND HYPOTHESIS

Dharmapala and Khanna [5] discuss CSR activity of India's 100 largest firms and the unintended consequences of Section 135 of the Indian Companies Act 2013. They examine the relationship between advertising expenditure and CSR expenditure. They found that certain firms' advertising expenditure declined with substitution of CSR and found decrease in CSR expenditure of firms which used to spend more than the mandated 2% before legislation.

Hepworth [6] is one of the first income smoothing studies and discusses the different methods adopted by management to smooth earnings. He identifies factors such as income tax benefits, stable dividend policy, and increased profits as incentives for smooth income management. DeFond and Park [7] argue that mangers are motivated to smooth income by the threat of losing their job. They find that when expected future earnings are good and current earnings are poor, managers borrow from future earnings. Current earnings are saved for future use if current earnings are good and expected to be poor in the future.

Previous literature documents various ways to detect income smoothing. Michelson and Charles [8] use Tobin's Q, The Modified Jones Model, Variance Ratio (VR), Earnings Trend, Earnings Model and Reported Revenue Model to investigate the relationship between income smoothing and firm value. They suggest researchers should select appropriate methodology based on the specific aspects of earnings management that is under investigation. Michelson, Wagner and

Wootton [9] examine the association between income smoothing and the response of the stock market to accounting performance measures. They find that businesses report high cumulative average abnormal returns with smooth income.

Literature shows mixed results for the relationship between earnings management and CSR. Prior [2] find a positive association between earnings management and CSR for regulated firms. In addition, Jordaan [10] finds a positive association between CSR and earnings management through income increasing discretionary accruals in listed South African companies for the years 2008, 2011, and 2013. Gras-Gil and Fernández [11] investigate the relationship between earnings management and CSR of companies in Spain. They find that managers of companies with high free cash flow and ROA engage more in earnings management.

Kang [12] examines the association of CSR and investor protection measures with earnings management practices in Asia. They find that firms with high financial performance engage less in earnings smoothing and show earnings aggressiveness in countries with stronger legal enforcement. They suggest increasing CSR and investor protection measures in order to reduce earnings management and improve the ease of doing business in Asia. Grecco [13] reviews the relationship between corporate social responsibility, earnings management (EM) and entity performance. They find that presenting information on the environment to the Global Reporting Initiative does not affect the performance of the entities and earnings management. The main results indicate that firms with higher ROA have higher added value, and such large companies are less prone to earnings management.

Hong and Anderson [14] investigate the relationship between CSR and earnings management by addressing two forms of earnings management: based on activity and based on accruals. They find evidence that firms which engage in CSR are less likely to manage earnings. The relationship between CSR and earnings management in 46 countries is investigated by Chih [15]. Investigate the relationship between CSR and earnings management in 46 countries. They find that firms which engage in CSR activities involve less in smoothing earnings. These companies also display less interest in avoiding earnings losses but they are prone to earnings aggressiveness.

The use of unspent CSR funds as a means of managing earnings does not seem to have been considered by previous literature. We therefore propose the following hypothesis:

H1: Companies that manage their earnings are more likely to have higher unspent CSR amounts.

III. METHODOLOGY

A. Sample

The sample used in this study is of 80 Bombay Stock Exchange listed companies. The study period is 2014-2017 and we are restricting our study to non-financial firms. Data was collected from annual reports, database of Prowess IQ, and portal of the National CSR (https://csr.gov.in) After calculating unspent CSR funds, we are left with a final sample of 50 companies having unspent CSR amount in any of the three years during the 2014-2017 period.

Model Specification

The purpose of this study is to investigate whether mandatory CSR legislation may be used for earnings management. A preliminary analysis was performed to identify unspent CSR amounts and their treatment in later years. Following previous studies we use the sales and income variation coefficient as income smoothing measures. We regress earnings management with unspent CSR and control variables to evaluate the effect of unspent CSR on earnings management. The equation for the regression is:

$$EMi = \beta 0 + \beta 1 \text{ Unspent CSR} + \beta 2 \text{ Size} + \beta 3 \text{ MB} + \beta 4 \text{ ROA} + \beta 5 \text{ LEV} + \varepsilon$$

B. Measurement of Earnings Management

Following Eckel [16] and Michelson and Charles [8] the coefficient of variation method is used to determine the presence of income smoothing. This method measures smoothing by considering the variables over time and in the general assumption that if changes in income are due to smoothing then coefficient of variation can be used to measure the variability of sales and income. A company is classified as an income smoother when the variability in sales is more than the variability in net income. Variability is measured as the coefficient of variation of the annual change in sales CV(S) compared to the coefficient of variation of the annual change in income CV (I).

C. Measurement of Unspent CSR

We calculated the amount of unspent CSR as the difference between mandatory CSR requirements and the actual CSR spent by the sample companies.

D. Measurement of Control Variables

The control variables used are Size, Market to Book (MB), Return on Assets (ROA) and Leverage (LEV). Following Jordaan [10] Size is considered to be the natural logarithm of market value of equity, and MB is calculated as market value of equity divided by book value of equity. ROA is calculated as profit before extraordinary items scaled by total assets and LEV is calculated by scaling long-term debt by total assets according to Prior [2].

IV. RESULTS AND DISCUSSION

From our preliminary analysis, we found that unspent CSR for 2014-15 is about 50% of the total CSR unspent of three years. It represents about 33% of the company's mandatory CSR requirement for 2014-15. Most companies stated in the annual report the reasons for not spending. For the 2014-15 annual report, for example, Idea Cellular Ltd. stated that the company had been in the process of identifying different focus areas for its CSR activities, consulting with different organizations and formulating key projects. Since it was a preparatory year to implement the CSR policy, they were unable to spend the required amount as required by law.

Unspent CSR for 2015-16 decreased to 21% of the 3-year total unspent CSR. This may indicate that

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companies had become familiar with the requirements of the Act and that internal controls were also in place. But in 2016-17, it increased slightly to 28%. This may be due to comply or declare policy of the government which gives businesses the freedom to either spend mandatory CSR expenditure or declare it in annual reports if not spent.

Table I Correlations

Pearson Correlation						
	Earnings mgt	Size	MB	ROA	LEV	Unspent
Earnings mgt	1.00	.06	-.08	-.21	.15	.24
Size	.06	1.00	-.18	.27	-.21	.27
MB	-.08	-.18	1.00	.43	.04	-.11
ROA	-.21	.27	.43	1.00	-.50	.01
LEV	.15	-.21	.041	-.50	1.00	-.01
Unspent	.24	.27	-.11	.01	-.08	1.00

Table I shows that correlation between the variables. There is a significant positive correlation of 0.239 between earnings management and unspent CSR. There is a significant negative correlation between ROA and earnings management and MB and earnings management. There is a positive correlation between earnings management and leverage, and size. High earnings management scores are associated with high unspent CSR scores, and low earnings management scores are associated with low unspent CSR scores. This basically supports our hypothesis that businesses with higher unspent CSR spending are more likely to engage in earnings management through revenue smoothing.

The following Table II shows the simple correlation represented by R-value shows that unspent CSR has a higher degree of correlation with EM as 0.108. Adjusted R^2 of 7.6% shows percentage variation in earnings management which is explained by all the variables together. R^2 change of control variable is only 6%, whereas unspent CSR shows an additional 4.7% of the earnings management variance. Sig. F Change is 0.007, less than 0.05, which shows that unspent CSR has a statistically significant contribution to predicting the EM. These results hold support for using unspent CSR as our independent variable.

Hierarchical Multiple Regression Analysis done gave the following results.

Table II Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics: R Square Change	F Change	df1	df2	Sig. F Change
	.246[a]	.060	.034	73.686	.060	2.270	4	141	.065
	.328[b]	.108	.076	72.067	.047	7.407	1	140	.007

a. Predictors: (Constant), LEV, MB, Size, ROA
b. Predictors: (Constant), LEV, MB, Size, ROA, Unspent

Table III Coefficients

Model		Unstandardized Coefficients B	Std. Error	Standardized Coefficients Beta	t	Sig.
	(Constant)	-136.626	107.025		-1.27	.204
	Size	12.772	8.249	.139	1.548	.124
	MB	.603	1.467	.042	.411	.682
	ROA	-203.287	103.175	-.231	-1.97	.051
	LEV	23.517	41.336	.057	.569	.570
	(Constant)	-70.991	107.416		-.661	.510
	Size	7.191	8.324	.079	.864	.389
	MB	.765	1.436	.053	.533	.595
	ROA	-198.845	100.921	-.224	-1.97	.051
	LEV	19.881	40.449	.048	.491	.624
	Unspent	.037	.014	.226	2.722	.007

The results demonstrate a positive and significant relationship between earnings management and unspent CSR. Unspent CSR has the largest unique contribution in EM after statistically removing the overlapping effects of all other variables, as the standard deviation beta is 0.226 with a significant value of less than 0.05. This provides strong evidence that companies that manage their earnings are more likely to have a higher unspent CSR amount. Therefore, our findings support our hypothesis. These results are consistent with [15] findings that less earnings management are performed by companies with lower unspent CSR.

V. CONCLUSION

This study looks at the relationship between mandatory CSR and earnings management in 80 non- financial companies listed on the Bombay Stock Exchange. We establish that companies that indulge in earnings management are more likely to have higher unused CSR amounts. These results are consistent with the findings of [14] and [15] that higher earnings management is performed by companies with higher unspent CSR. We also found a significant increase in CSR activity among companies that used to spent less than the mandated 2%, but those companies that used to spent more than 2% initially reduced their CSR spending after the mandate. Some companies like Motherson Sumi Systems Ltd, H C L Technologies Ltd, Bharti Airtel Ltd, and Petronet LNG Ltd display a trend of increasing unspent CSR amount over the years. These findings provide new evidence to support the Government of India's adoption of a more elaborate CSR monitoring mechanism and implementation strategy.

A Centralized Scrutiny and Prosecution Mechanism was established by the Ministry of Corporate Affairs in April 2018 to enforce the provisions of the CSR mandate. They also proposed amendments to the law and suggested unused CSR amounts be transferred to a separate bank account and to be spent within a fixed time period. Thus, companies are compelled to spend money allocated towards CSR instead of allowing them to accumulate in the balance sheet. These changes reinforce our study and its findings.

We suggest that government should ensure that the unused CSR amounts brought forward are used exclusively for CSR activities. Firms should be directed to deposit the unused money in government funds such as Clean Ganga Fund or Swachh Bharat Kosh; if this amount is not committed to multi-year and long-term CSR projects.

There are some limitations to our study. First, our study period is restricted because mandatory CSR expenditure came into effect from the 2014 financial year and so our study period is limited to the 2014-2017 financial years. Secondly, our results depend heavily on the method of calculating income smoothing. We have used the coefficient of variation method instead of other methods in the general assumption that if changes in income are high without change being reflected in sales, it may be due to the presence of income smoothing.

Overall, we conclude that unused CSR funds could be used by companies as a mechanism for managing reported earnings. Increasing efforts to improve CSR monitoring policies can therefore reduce the unintended impact of mandatory CSR legislation.

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