INTERRELATIONSHIP BETWEEN EARNINGS MANAGEMENT AND CORPORATE SOCIAL RESPONSIBILITY REPORTING

Research on Indonesian Listed Companies in BEI for 2012-2013

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Submitted by :

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I, Alif Rishal Prasetya, hereby state and declare that this thesis is true and accurate to be my own work specially written for partial requirement to complete Undergraduate Program of Accounting and has not initially been presented in any other occasion. I bear full responsibility for my undergraduate thesis.

Alif Rishal Prasetya

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MOTTO AND DEDICATION

فَإِن تَوَلَّوْا فَقُلْ حَسْبِيَ اللَّهُ لَا إِلَٰهَ إِلَّا هُوَ ۖ عَلَيْهِ تَوَكَّلْتُ ۖ وَهُوَ رَبُّ الْعَرْشِ الْعَظِيمِ

But if they turn away, say, "Sufficient for me is Allah ; there is no deity except Him. On Him I have relied, and He is the Lord of the Great Throne."

– QS. At Taubah : 129

فَإِنَّ مَعَ الْعُسْرِ يُسْرًا

For indeed, with hardship [will be] ease. – QS. Al Insyirah : 5

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My beloved brother, Ainur Muhti Ashari

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All of my beloved friends

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ABSTRACT

This research aims to examine the interrelationship between earnings management (EM) and corporate social responsibility reporting (CSR). This research uses GRI G3.1 Indeces to measure CSR while earnings management is measured with real activities manipulation proxie.

Population of this research is all Indonesian Listed Companies in Indonesian Stock Exchange for the year 2012 and 2013. Companies from financial and banking groups are excluded because they have the characteristics of assets which are very different from the other industries. Two-Stages Least Squares (2SLS) Analysis on SPSS22 is used to examine the data.

This research indicates that there is simoultanity relationship between earnings management and CSR reporting. But then, only CSR reporting which affects earnings management practices, but it isn't found prove that earnings management affects CSR reporting.

Keywords : earnings management, corporate social responsibility reporting, real activities manipulation, simoultanity relationship

ABSTRAK

Penelitian ini bertujuan untuk menguji hubungan antara manajemen laba (EM) dan pelaporan tanggung jawab sosial perusahaan (CSR). Penelitian ini menggunakan Index GRI G3.1 untuk megukur CSR sedangkan manjemen laba diukur dengan proksi aktivitas manipulasi riil.

Populasi dari penelitian ini adalah seluruh Perusahaan yang telah tercatat di Bursa Efek Indonesia untuk periode tahun 2012 dan 2013. Perusahaan-perusahaan dari kelompok finansial dan perbankan tidak dilibatkan dalam penelitian karena kelompok ini memiliki karakteristik aset yang sangat berbeda dengan industri lainnya. Analisis 2SLS pada SPSS22 digunakan untuk melakukan uji pada data.

This research indicates that there is simoultant relationship between earnings management and CSR reporting. But then, only CSR reporting which affects earnings management practices, but it isn't found prove that earnings management affects CSR reporting.

Penelitian ini mengindikasikan bahwa terdapat hubungan simultan antara manajemen laba (EM) dan pelaporan tanggung jawab sosial perusahaan (CSR). Selanjutnya, ditemukan bahwa hanya pelaporan CSR yang memiliki pengaruh pada praktik manajemen laba tetapi tidak ditemukan bukti bahwa praktik manajemen laba mempengaruhi pelaporan CSR.

Kata kunci : manajemen laba, pelaporan CSR,aktivitas manipulasi riil, hubungan simultan

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CHAPTER I

INTRODUCTION

This chapter explains the phenomena of corporate social responsibility practices and earnings management conducted by firms. This chapter consist of background, research questions, purposes of the research, usefulness of the research, and structure of the thesis. Researcher will explain the reasons why corporate social responsibility practices and earnings management conducted by firms is important to be examined in the background. The relationship between corporate social responsibility practices and earnings management will be asked in research questions part. The functions of this research will be explained in the purposes and usefulness of the research part. Finally, structure of the thesis part will describe each of the chapters in this thesis.

1.1 Background

Nowadays, firms must have social responsibilities beside of their main role in generating profit through their operational. According to Epstein et al., (1976) firms are not only considered to have fulfiled their responsibilities in operating the firm in accordance with the law, bring about profit, and provide employment for members of society but also to be socially responsible towards the society where they operate. Furthermore, Adebayo (2000) explained that firm should engage more in pollution reduction, effectiveness and efficiency in natural resources usage, racial and sexual discrimination abolition, employment for minorities and women provision. Firm activities in order to meet their social responsibilities called as Corporate Social Responsibility (CSR).

Several experts propose some definitions regarding CSR. Marnelly (2012) explained that there are two types in the concept of CSR, namely in the broad term and in narrow term. CSR in the broad term closely related to the goal of achieving sustainable economic activity. Furthermore, Marnelly (2012) explained that sustainability in economic activity is not only to make social responsibility but also regarding corporate accountability to the community and nation as well as international society. CSR in narrow term can be understood from expert opinion such as Widjaja and Jeremiah (2008) who describe CSR as a form of cooperation between company and all stake-holders that directly or indirectly interact with the company to keep ensuring the existence and sustainability of companies.

Corporate social reporting is considered to be something in common due to investors' demand, customers and other stakeholders regarding more transparant information in many business aspects (Kim et al., 2012). Further, Rahmatullah (2012) state that CSR will not only bring benefits for the firm but also for the society, environment and country where the firm operates its business.

There is a significant increasing on concern toward CSR disclosure in Indonesia (Siregar, 2010). The phenomenon of CSR disclosure is becoming more prominent in Indonesia after the issuance of Law No. 40 of 2007 section 74 of the Corporation set regarding social responsibility and enterprise environments.

Regulation affirmed the obligation to carry out and report on CSR especially for companies whose business activities related to natural resource usage.

Approval of these regulations bring a shift on activity and changes in regulation which is firstly CSR reporting is voluntary became mandatory for some industrial sectors. Thus, CSR reporting practices increasingly seen as important part from the perspective of the company with a variety of motives, one of which is to meet the requirements in the legislation.

The other Law that controls the CSR especially for environment scope is Law No. 32 of 2009 on Environmental Protection and Management. Based on that Law, as stated in Article 68, everyone who undertakes the business and/or activities must be obliged to:

a. provide information related to environmental protection and management truthfully, transparently, and punctually;
b. preserve environmental sustainbility functions; and
c. abide by the provision on the quality standard of environment and/or standard criteria for environmental damage.

Management is responsible for providing stakeholders with information regarding various entity activities, which can be achieved through financial reporting. However, the inherent flexibility in many accounting standards facilitate managers to take advantage of it and misrepresent information (Alves, 2013).

Hemingway and Maclagan (2004) state that manager could probably to keep CSR activities to cover the corporate's bad side (cited by Kim et al., 2012).

Gray, Kouhy, and Lavers (1995) claim that CSR practice performed by firms is used to manipulate the informational needs of the various powerful stakeholder groups in society such as employees, stockholders, nongovernmental agencies and general public so as to gain their support, which is required for survival (cited by Grougiou, 2014).

McWilliams et al. (2006) argues that CSR practices can potentially be linked to the pursuit of a manager's self-interest (cited by Kim et al., 2012). If managers engage in CSR practices based on opportunistic incentives, then they are likely to mislead stakeholders as to the value of the firm and financial performance. If these incentives prevail, then the researcher would observe a positive relation between CSR and earnings management.

CSR reporting is considered to be an important tool in giving constraint toward EM practices. It can provide transparent and reliable financial information as part of accountability for stakeholders which is on the other side can be used by management to cover its EM practices, therefore there are some researchers who examine this association.

Barri Litt (2014) finds that there is significant negative association between EM and environmental reporting initiative. The same result regarding negative association between EM and CSR reporting also found on Kim et al. (2012). Using two main different proxies on measuring EM, it can be concluded that CSR firms are less likely to engage in aggresive earnings management through discretionary or real activity manipulation. Contradictively, Grougiou et al. (2014) and Prior et al. (2008) claim possitive relationship between EM and

CSR reporting. Grougiou et al. (2014) support that there is a positive association between EM and CSR on 116 commercial banks in USA during 2003-2007. It is believed that bank managers who manipulate earnings tend to intensify their involvement in CSR activity. While Prior et al. (2008) considers that there is a positive relationship between EM and CSR and the combination among EM and CSR affect financial performance.

There are three reasons that underpinning this study. First, there are differences in the perspective of the previous research in how to measure EM. Discretionary accruals or model of Jones (1991) was used to measure the EM with indicators of income smoothing, earnings losses avoidance, and earnings aggressiveness (Chih et al. (2008); Prior et al. (2008); Litt et al. (2014)). Kim et al., (2012) research used three combination of EM measurement. They are the discretionary accruals, real activities manipulation and Accounting and Auditing Enforcement Releases (AAERs). Second, there are inconsistency of the results of the prior research related to EM and CSR. Among them is the research of Chih et al. (2008) who found that CSR tends to reduce the practice of income smoothing, reduce loss avoidance practices and profit decline, but still there is a trend in earnings aggressiveness. Positive relationship between EM and CSR is found in the study Prior et al. (2008), while the results research conducted by Kim et al. (2012) revealed that EM negatively related to CSR. While Litt e.al (2014) found negative association between EM and CSR. Third, there is few research which examine simoultaneous association between CSR and EM practice. One of them is Grogiou et al. (2014) which found that there is simoultant association among

CSR and EM practices on U.S. Banks. From those reasons, it is necessary to conduct more in-depth study by conducting research on the relationship between EM and CSR.

Following Roychowdury (2006) and Kim et al. (2012), Real activities manipulation (RAM) proxie will be used to measure EM in this research. There are three reasons of using RAM as proxie to measure EM. First, accrual manipulation is more likely attract the attention of auditors and supervisors compared to firm policy about pricing and production (Roychowdury, 2006). Second, relying on accrual manipulation alone cause the risk. Real activities can not be manipulated by the end of the year. In addition, for the case in Indonesia, Ratmono (2010) finds empirical evidence that beside of conducting accrual-based earnings management, Indonesian listed companies also perform earnings management through real activities manipulation (cited by Yuliarti, 2014).

This research contributes to the literature in several ways. First, the research provides reliable evidence on relationship between earnings management practices and CSR practice. This research uses two-stages least squares (2SLS) analysis to accomodate simoultaneous issue among earnings management practices and CSR practice following suggestion from Prior et al. (2008). Second, this research has important implication for investing community. When it is proved that the more number of CSR items disclosed reveals that the deeper firms' involvement in EM through real activities manipulation, the investors could make better analysis and economics decisions by avoiding less reliable information given by the firms.

1.2 Research Questions

Based on the previous explanation, CSR has important role on providing financial report which is more transparant and could limit EM practice. On the other hand, CSR could be used as a tool for management to cover its EM practice. Hence, the researcher is interested to have research in this case to have deeper insight toward the relation between CSR and EM practice.

It can be found that there are many contradictive result regarding research on association between CSR and EM practice. It also found that CSR is commonly chosen as independent variable to determine EM practice level, vice versa. Furthermore, there are several different perspective on using proxy to measure EM practice, they are discretionary accruals and real activities. Using real activities measure which is believed by researcher to have better result, the questions on this research are formulated as follow :

1. Does CSR reporting affect earnings management practice?
2. Does earnings management practice affect CSR reporting?

1.3 Purpose and Usefulnes

The purpose of this research are :

1. to analyse whether earnings management practice affects CSR reporting or not
2. to analyse whether CSR reporting affects earnings management practice or not

The usefulnes of this research toward academic and practice level are :

1. The result of this research is hoped to give academic contribution on theory development which is related with earnings management, financial accounting, and discussion regarding corporate social responsibility reporting and earnings management.
2. The result of this research is hoped to give broader insight to CEO in implementing CSR reporting wisely for investors, investor candidates and another market stakeholder which use report published by firm regarding its earnings and CSR practice.
3. The result of this research is hoped to give information and referrence for related stakeholder to get information needed.

1.4 Structure of the Thesis

This thesis structure is divided into five chapters as follows:

CHAPTER I : INTRODUCTION

This chapter will explain about the background of this study practiced, statement of the problem, research purposes and benefits, and research systematic.

CHAPTER II : LITERATURE REVIEW

This chapter will explain about the literatures used for the study as the theoretical basis, the previous studies, framework and the hypothesis.

CHAPTER III : RESEARCH METHOD

This chapter will explain about variables used in the study, sampling and data, analysis method, data processing, and hypothesis testing.

CHAPTER IV : RESULTS AND DISCUSSIONS

This chapter will explain and describe about the research objects which consists of sample overview, the results of data processing, and the results and implications of study.

CHAPTER V : CONCLUSIONS AND SUGGESTIONS

This chapter will conclude and explain the conclusions of the research, limitations during the research process and give some suggestions for the next researchers.

CHAPTER II
LITERATURE REVIEW

This chapter explains the theory which underpinning the research on firm's corporate social responsibilities and earnings management. Previous researches regarding firm's corporate social responsibilities and earnings management will be presented after it. Finally, this chapter will present the research framework and explain the hypothesis of this thesis.

2.1 Theoritical Background

In this part, researcher will explain the theory underpinning the research question. The researcher will also describe some definition regarding the research subject.

2.1.1 Legitimacy Theory

Approval from the community is the main idea of the legitimacy theory. Basically, an institution is a system consisting some parts which work based on its own function. Then this system interacts in a larger system called social systems. There are several conditions that must be met when two systems interact. The interaction of both should run without any obstacle. Since the social system has heterogenous individuals which have different values and culture in it, the company must follow the norms and some rules of it, so it gets an approval from the social system. Gray et al. (1995) states as follows:

"... A condition or status of the which exists when an entity value system is congruent with the value system of the larger social system of the which the entity is a part. When a potential or actual disparity that exist between two values system, there is a threat to the entity legitimacy ".

The legitimacy theory is based on the existence of social contact between an instutitution with the community, which required a congruent purpose between the institution and the values that are believed a community. Based on this theory, every actions taken by an institution must be accepted by society. Suchman (1995) states that legitimacy is sought by organizations as it affects the understanding and actions of people towards the organization.

Legitimacy theory is very useful to analyse institutional behavior which the main focus is to determine how far the boundaries of the values in a social community is run, as well as in how much value were violated. All social institutions ultimately provide the output of operations to the public, either through the distribution of economic benefits, as well as social benefits. Besides, there are limitations in the form of regulations, where norm as unwritten rules, and regulations that more commonly referred to as the legal.

2.1.2 Stakeholder-Agency Theory

Stakeholder-agency theory derived from Stakeholder and Agency Theory. Hill and Jones (1992) proposes this paradigm to help in explaining certain aspects of firm's strategic behaviour, relationship between structure of management and stakeholder contracts, the form taken by institutional structures that monitor and enforce contracts between managers and other stakeholders; and the evolutionary process that shapes both management-stakeholder contracts and the institutional structures that police those contracts.

Jensen and Meckling (1976) confirm that agency theory has been developed as the dominant paradigm in the financial economics research over the last decade (cited by Hill, W and Jones, T, 1992). Hendriksen and Breda (2001) present that agency theory is a model which explain two individuals role in a business. One individual is called principal, while the another one called agent. The relationship between principal and agent could be drawn as owner of business and the management of that business. The principal's roles are to give reward to the agent for duties completed; the agent's roles are to perform duties given by principal.

However, there is the nature of implicit and explicit contractual relationship that exist between a firm's shareholder which has not been relatively unexplored by the abbility of agency theory due to the growth of business recently. Stakeholder theory explain that the company is not the only entity that operates for its own sake, but also should be able to provide benefits for the stakeholders. Thus, the existence of a company is strongly influenced by the support provided by the company stakeholders (Ghozali and Chariri, 2007). Stakeholders can basically control or have the ability to influence the use of economic resources used by the company. These capabilities can be the ability to restrict the use of limited economic resources such as capital and labor, access to influential media, the ability to manage the company, or the ability to influence the consumption of goods and services produced by the company. Stakeholder-

Agency theory can be viewed as modification of agency theory to accomodate theories of power including resource dependence theory of organization (Hill and Jones, 1992, pp.151).

Stakeholder-agency theory is not only consider firm as a nexus of contracts between resource holder, but also encompasses the implicit and explicit contractual relationship between all stakeholders (Hill and Jones, pp.132). Each stakeholder disregarding the power of their stake is a part of the nexus of implicit and explicit contracts that establish a firm.(Hill and Jones, 1992, pp.134).

Further, Hill and Jones (1992) explain that in the term of stakeholder-agency theory, managers have unique role model which is not only as the agent of firm's principal but also the agent of other stakeholder. It can't be concluded that other stakeholders are manager's pricipal since explained by agency theory previously that principal hires manager to conduct duties and give reward when the duties completed, but in this case the manager only hired by the firm. In spite of that, there is an association between the general class of stakeholder-agent relationship and the principal-agent relationship which involve an implicit and explicit contract to accomodate different interest (Hill and Jones, 1992, pp.134). In tune, Prior et al. (2008, h.162) argues that managers not only have a relationship or association with the business owners or shareholders, but also with other stakeholders in the company.

Stakeholder-agency theory illustrate that the amount of resources that used by management to achieve the corporate goal can be reduced due to the claim of stakeholders when they feel satisfied (Hill and Jones, 1992, pp.137). The claims could be come from employee, consumer, supplier, and local community. Higher wages will be claimed by satisfying employee, better quality and lower price will be claimed by consumer, higher price and more stable ordering cycle will be claimed by supplier, and lower level of pollution together along with better quality of life will be claimed by local community. So, an agency conflict is implicit in the relationship between management and all other stakeholders (Hill and Jones, 1992, pp.138).

Based on the explanation of stakeholder-agency theory above, the relationship between CSR and EM practice can be explained by using this theoretical basis. Hill and Jones (1992) argued that any decision taken by the manager will affect for all groups stakeholders, in this case the manager can be viewed as stakeholders' agent, not only as shareholders' agent. Further, Prior et al. (2008) state that a manager who involves in earnings mangements practices will use entrenchment strategy by trying to involve as many stakeholders as possible as a way to validate their actionstand. This action will reduce the flexibility in the organization and affect its financial results harmly. Additionally, Friedman (1970) and Jensen (2001) argue that socially responsible initiatives areinvestments without payoffs and, therefore, against theshareholder's best interest (cited by Prior et al., 2008, pp.163)

2.1.2 Corporate Social Responsibility

In the global context, the term Corporate Social Responsibility (CSR) was popularized through the book Cannibals With Forks: The Triple Bottom Line of 21st Century Business (1998), by John Elkington. CSR developed into three essential components of sustainable development. They are economic growth, environmental protection and social equity, which was initiated by the World Commission on Environment and Development (WCED) in the Brundtland Report (1987). Further, CSR is divided into three focus: 3P, stands for profit , planets and people. The company should not just look for economic profit (profit) but also put concern for the environment (planet) and the welfare of society (people) (Marnelly, 2012).

There are some definition regarding CSR. Kuo and Chen (2013) stated that CSR is a form of corporate self-regulation integrated into a business model that considers the economic, social, and environmental dimentions of a firm's activities. CSR aims to favor business pursuit of sustainable development as expressed by the triple bottom line. Environmental management is an important part since companies and communities are paying increasing attention to the idea of corporate social responsibility (Lamond, 2007).

International Standard Organization (ISO) postulate ISO 26000 (2011) regarding Guidance Standard on Social Responsibility. Definition of CSR based on ISO 26000 (Rahmatullah, 2012) is that :

> *Responsibility of an organization for the impacts of its decisions and activities on society and the environment, through transparent and ethical behavior that contributes to sustainable development, including health and the welfare of society; takes into account the expectation of stakeholders; is in compliance with applicable law and consistent with*

international norms of behavior; and is integrated throughtout the organization and practiced in its relationship.

Based on ISO 26000 definition about CSR, CSR is not only about its operational practice. Every organisation which has impacts regarding their decisions and activities on society and the environment is recommended to run CSR activities.

Business industry in a country usually has its own regulation. Corporation which involved in an industry which has regulation besides the state regulation enacted by government, are likely has socially responsibility behavior than the one that does not (Listyani, 2014). It is not only the presence of industry regulation or self-regulation that can encourage a corporate to socially responsible, but also a well-organized system and effective self-regulation. Indonesia has regulation regarding CSR practice on Law No.40 of 2007 in Article 1 point 3 which explain that :

Social and environmental responsibility is a company committed acts to get involved in sustainable economic development to improve the quality of life and beneficial environmental, for the company, the local community, and as well as for the society.

From the law above, it can be concluded that a company is not only responsible for its own operational but also should be actively responsible to the social environment. Company is not only obliged to be responsible to the shareholders, creditors, suppliers, but also to the employee, local community and society to provide and enhance their quality of life.

2.1.3 Corporate Social Responsibility Reporting

Firms could prepare CSR report to inform shareholders and other stakeholders about a firm's CSR activities (Siregar, 2010). According to Gray et al. (1987), CSR reporting is the process of communicating the social and environmental effects of organisations' economic actions to particular interest groups within society and to society at large. Based on the definition above, CSR reporting involves extending the accountability of companies beyond role of providing a financial account to the shareholders. CSR report shows that companies have wider responsibility than just to pursue profit.

According to Hendriksen and Breda (1992, pp.856), there are three concept of disclosure reporting. They are adequate, fair, and and full disclosure. Adequate disclosure which is commonly used only implies a minimum amount of information as long as it is adequate to not lead the user into wrong understanding of the readers. Fair disclosure implies ceratin ethical purpose to provide equal treatment for all potential reader. Meanwhile, full disclosure means the presentation of all relevant information to the readers.

The issuance of Law No. 40 of 2007, particularly in article 74, paragraph 1 states that the company which carries on business in the field of natural resources and areas relating to natural resources required to implement CSR. Furthermore, there is the implication that the companies are required to report their CSR implementation.

2.1.4 Global Reporting Intiative (GRI) Index

Global Reporting Initiative (GRI) is an organization which release reporting framework in a form of index to measure, track, and drive economic sustainability of organizations. GRI started its index release in 1997 with the mission to fulfil need of globally shared framework of concepts, consistent language, and metrics required to support clearly and openly commonication about sustainbility by providing a trusted and credible framework for sustainability reporting that can be used by organizations of any size, sector, or location.

Based on Sustainability Reporting Guidelines G3.1, here are the GRI's indicator explanation and all of each its items or indicator performance:

a. Environmental

   The environmental dimension of sustainability concerns an organization's impacts on living and non-living natural systems, including ecosystems, land, air, and water. Environmental Indicators cover performance related to inputs (e.g., material, energy, water) and outputs (e.g., emissions, effluents, waste). In addition, they cover performance related to biodiversity, environmental compliance, and other relevant information such as environmental expenditure and the impacts of products and services.

Table 2.1

Environmental Indicators

Aspects	Code	Explanations
Materials	EN1	Material used by weight or volume.
	EN2	Percentages of material used that are recycled input materials.
Energy	EN3	Direct energy consumption by primary energy source.
	EN4	InDdirect energy consumption by primary energy source.
	EN5	Energy saved due to conservation and efficiency improvement.
	EN6	Initiatives to provide energy-efficient or renewable energy based products and services, and reductions in energy requirements as a result of these inititiatives.
	EN7	Initiative to reduce indirect energy consumption and reductions achieved.
Water	EN8	Total water withdrawal by source.
	EN9	Water sources significantly affected by withdrawal of water.
	EN10	Percentage and total volume of water recycled and reused.
Biodiversity	EN11	Location and size of land owned, leased, managed in, or adjacent to, protected areas and areas of high biodiversity value outside protected area.
	EN12	Description of significant impacts of activities, products, and services on biodiversity in protected areas and areas of high biodiversity value outside protected area.
	EN13	Habitats protected or restored.
	EN14	Strategies, current actions, and future plans for managing impacts on biodiversity
	EN15	Number of IUCN Red List species and natural conservation list species with habitats in areas affected by operations, by level of extinction risk.
Emissions, Effluents, and Waste	EN16	Total direct and indirect greenhouse gas emissions by weight.
	EN17	Other relevant indirect greenhouse gas emissions by weight.
	EN18	Initiatives to reduce greenhouse gas emissions and reductions achieved.
	EN19	Emissions of ozone-depleting substance by weight.

	EN20	NO, SO, and other significant air emissions by type and weight.
	EN21	Total water discharge by quality and destination.
	EN22	Total weight of waste by type and disposal method.
	EN23	Total number and volume of significant spills.
	EN24	Weight of transported, imported, exported, or treated waste deemed hazardous under the term of Basel Convention Annex I, II, III, and VIII, and percentage of transported waste shipped internationally.
	EN25	Identity, size, protected status, and biodiversity value of water bodies and related habitats significantly affected by the reporting organization's discharge of water and runoff.
Products and Services	EN26	Initiatives to mitigate environmental impacts of products and services, and extent of impact mitigation.
	EN27	Percentage of products sold and their packaging materials that are reclaimed by category.
Compliance	EN28	Monetar value of significant fines and total number of non-monetary sanctions for noncompliance with environmental laws and regulations.
Transport	EN29	Significant environmental impacts of transporting products and other goods and materials used for the organization's operation, and transporting members of the workforce.
	EN30	Total environmental protection expenditures and investments by type.

b. Labor Practices and Decent Work

The specific Aspects under the category of Labor Practices are based on internationally recognized universal standards, including:

- United Nations Universal Declaration of Human Rights;
- United Nations Convention: International Covenant on Civil and Political Rights;

- United Nations Convention: International Covenant on Economic, Social, and Cultural Rights; Convention on the Elimination of all Forms of Discrimination against Women (CEDAW);
- ILO Declaration of Fundamental Principles and Rights at Work (in particular the eight core Conventions of the ILO consisting of Conventions 100, 111, 87, 98, 138, 182, 29, 105); and The Vienna Declaration and Programme of Action.

Table 2.2
Labor Practice and Decent Work Indicators

Aspects	Code	Explanations
Employment	LA1	Total workforce by employment type, employment contract, and region, broken down by gender.
	LA2	Total number and rate of new employee hires and employee turnover by age group, gender, and region.
	LA3	Benefits provided to full time employees that are not provided to temporary or part-time employees, by significant location of operation.
	LA4	Percentage of employees covered by collective bargaining agreements.
	LA5	Minimum notices period(s) regarding operational charges, including whetherit is specified in collective agreements.
Occupational Health and Safety	LA6	Percentage of total workforce represented in formal joint management-worker health and safety committees that help monitor and advise on occupational health and safety programs.
	LA7	Rates of injury, occupational disease, lost days, and abstenteeism, and total number of work-related facilities, by region and by gender.
	LA8	Education, training, counseling, prevention, and risk-control programs in place to assist workforce members, their families, or community members regarding serious disease.

	LA9	Health and safety topics covered in formal agreements with trade unions.
Training and Education	LA10	Average hours of training per year per employee by gender, and by employee category.
	LA11	Programs for skills management and lifelon learnings that support the continued employability of employees and assist them in managing career ending.
	LA12	Percentage of employees receiving regular performance and career development reviews, by gender.
Diversity and Equal Opportunity	LA13	Composition of governance bodies and breakdown of employees per employee category according to gender, age group, minority group membership, and other indicators of diversity.
Equal Remuneration for Women and Men	LA14	Ratio of basic salary and remuneration of women to men by employee category, by significant locations of operation.
	LA15	Return to work and retention rates after parental leave, by gender.

c. Human Right

Human rights Performance Indicators require organizations to report on the extent to which processes have been implemented, on incidents of human rights violations and on changes in the stakeholders' ability to enjoy and exercise their human rights, occurring during the reporting period.

Table 2.3
Human Right Indicators

Aspects	Code	Explanations
Investment and Procurement Practices	HR1	Percentage and total number of significant investment agreements and contracts that include clauses incorporating human right concerns, or that have undergone human right screening.
	HR2	Percentage of significant suppliers,

		contractors, and other business partner that have undergone human rights screening, and actions taken.
	HR3	Total hours of employee training on policies and procedures concerning aspects of human rights that are relevant to operations, including the percentage of employees trained.
Non-Discrimination	HR4	Total number of incidents of discrimination and corrective action taken.
Freedoom of Association and Collective Bargaining	HR5	Operation and significan suppliers identified in which the right to exercise freedom of association and collective bargaining may be violated or at significant risk, and action taken to support this right.
Child Labor	HR6	Operation and significan suppliers identified as having significant risk for incidents of child labor, and measures taken to contribute to the effective abolition of child labor.
Forced and Compulsary Labor	HR7	Operation and significan suppliers identified as having significant risk for incidents of forced or compulsory labor, and measure to contribute to the elimination of all forms of forced or compulsory labor.
Security Practices	HR8	Percentage of security personnel trained in the organization's policies or procedured concerning aspects of human rights that are relevant to operations.
Indigenous Rights	HR9	Total number of incidents of violations involving rights of indigenous people and actions taken.
Assessment	HR10	Percentage and total number of operations that have been subject to human rights reviews and/ or impact assessments.
Remediation	HR11	Number of grievances related to human rights filed, addresed and resolved through formal grievance mechanism.

d. Society

Society Performance Indicators have focus attention on the impacts of organizations toward the local communities in which they operate and the way they manage and mediate risks that may arise from interactions with other social institutions.

Table 2.4
Society Indicator

Aspects	Code	Explanations
Local Communitiies	SO1	Percentage of operations with implemented local community engagement, impact assesment, and development programs.
	SO9	Operations with significant potential or actual negative impacts on local communities.
	SO10	Prevention and mitigation measures implemented in operations with significant potential or actual negative impacts on local communities.
Corruption	SO2	Percentage and total number of business unit analyzed for risks related to corruption.
	SO3	Percentage of employees trained in organization's anti-corruption policies and procedures.
	SO4	Actions taken in response to incidents of corruption.
Public Policy	SO5	Public Policy positions and participation in public policy development and lobbying.
	SO6	Total value of financial and in-kind contributions to political parties, politicians, and related institutions by country.
Anti-Competitive Behaviour	SO7	Total number of illegal actions for anti competitive behavior, anti-trust, and monopoly practices and their outcomes.
Compliance	SO8	Monetary value of significant fines and total number of non-monetary sanctions for non-compliance with law and regulations.

e. Product Responsibility

Society Performance Indicators have focus attention on the impacts of organizations toward the local communities in which they operate and the way they manage and mediate risks that may arise from interactions with other social institutions.

Table 2.5

Product Responsibilty Indicators

Aspects	Code	Explanations
Customer Health and Safety	PR1	Life cycle stages in which health and safety impacts of products and services are assesed for improvement, and percentage of significant products and services categories subject to such procedures.
	PR2	Total number of incidents of non-compliance with regulations and voluntary codes concerning helath and safety impacts of products and services during their life cycle, by type of outcomes.
Product and Service Labeling	PR3	Type of product and service information required by procedures, and percentage of signifivcant products and services subject to such information requirements.
	PR4	Total number of incidents of non-compliance with regulation and voluntary codes concerning product and service information and labeling, by type of outcomes.
	PR5	Practices to related customer satisfaction, including results of survey measuring customer satisfaction.
Marketing Communication	PR6	Programs of adherence to law, standards, and voluntary codes related to marketing communication, including advertising, promotion, and sponsorship.
	PR7	Total number of incidents of non-compliance with regulation and voluntary codes concerning marketing communication, including advertising,

		promotion, and sponsorship by type of outcomes.
Customer Privacy	PR8	Total number of substantiated complaints regarding breaches of customer privacy and losses of customer data.
Compliance	PR9	Monetary value of significant fines for non-compliance with laws and regulations concerning the provision and use of products and services.

2.1.5 Earnings Management

In this part, researcher will explain the concept of earnings management. Furthermore, it will be explained about the motivations of managers on performing earnings management and several ways to measure earnings management.

2.1.5.1 Earnings Management Definition

There are several definition about earnings management regarding some literatures. According to Healy and Wahlen (1999, pp.368), earnings management occurs when managers use judgement in financial reporting and in structuring transaction to alter financial reports to either mislead some stakeholders about underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting practices. Schipper (1989) defines earnings management as an effort to intervene in the process of preparation of external financial reporting in order to gain personal benefits.

Earnings management practice can be explained from two different points of view, business ethics and positive accounting theory (Godfrey et al., 1997). The reasons why mangers perform earnings mangement can be analyzed through business ethics. While various forms of earnings mangement practice performed by managers can be identified through positive accounting theory.

Overview of ethics earnings management from the perspective of positive accounting theory can be explained through the theory of contract. Godfrey et al. (1997) explained that research and and positive accounting theory are based on assumptions about individual behaviour which is involved in a contract. The contract process results an agency relationship. An agency relationship appears when business owner (principal) hires agent to perform some duties. Principal delegates the decision making authority to the agent. Both principal and agent are utility maximizer. There is no assurance that agent will always perform duties for the sake of principal.

2.1.5.2 Motivations on Earnings Management

There are several theories about the motivation of earnings management. Watts and Zimmerman (1986) suggests three factors associated with the behavior of managers in the selection of accounting policies. These three factors referred to three hypotheses positive accounting theory.

1. Bonus Plan Hypothesis

   This hypothesis talked about the selection of accounting methods for a bonus plan manager. If the amount of bonus to be gained by managers is based on the profits generated, managers will tend to choose accounting methods that can increase the earnings that also will increase the bonus earned. If the bonus agreement for the manager has an upper limit to the amount that can be accepted, then the earnings of a period that higher than the upper limit of the target profit for the bonuses will give the initiative for managers to reduce reported earnings in the period and profit will be transfered in the next period.

2. Debt Covenant Hypothesis

   Debt agreements have requirements that must be met which include the debtor's willingness to maintain accounting ratios such as debt to equity ratio, minimum working capital ratio, as well as other restrictions that are generally associated with enterprise accounting data. If those aggrements are broken, there will be sanctioned restrictions on the payment of dividends or additional restrictions on debt. High earnings are expected to reduce the possibility of a debt covenant violation of these terms. Managers are expected to tend to choose accounting policies that increase profitability.

3. Political Cost Hypothesis

   This hypothesis states that the company which is dealing with political costs tend to decrease the profit with the goal to minimize the political costs they incur (Scott, 1997 pp.303). Political costs concerning all costs (transfer of property) to be borne by the company related to political action such as anti-trust, government subsidies, taxes and tariffs, competition with foreign companies, as well as other regulations (Watts and Zimmerman, 1978). In addition, earnings management can be used to overcome the competition with foreign companies.In order to obtain such protection, the company will choose accounting policies that lower earnings so that their earnings looked lessen as a result of competition with foreign companies.

2.1.6 Real Activity Manipulation

Roychowdhury (2006, pp.337) defined real activities manipulation as a deviation from normal operational practice which is driven by the managers' desire to mislead at least some of the stakeholders in order to believe that the purposes of certain financial reporting has been fulfilled in normal operations. Such deviation is not always contribute to the value of the company although managers succeed to meet reporting purposes. Real activities manipulation methods such as discounts and reductions discretionary spending is probably the optimal action in state particular economy. Graham et al. (2005) argued that companies tend to conduct real activities manipulation to meet the target, although manipulation can reduce the value of the company (cited by Roychowdhury, 2006). Real activities manipulation can reduce the value of company for actions taken within a certain period to increase profits can have a negative impact on cash flow on the next period. For example, aggressive discounts to increase sales volume to meet short-term earnings targets may cause customers to expect a discount in future periods. This can lead to lower margins on future sales.

In this study, the proxy which will be used to detect earnings management is real activities manipulation. According to survey conducted by Bruns and Merchant (1990) and Graham et al. (2005), financial executives showed a greater desire to perform earnings management through the activity of the real manipulation rather than accrual (cited by Roychowdhury (2006, pp.338).

There are two reasons underlying this finding. First, accrual manipulation is more likely to attract auditors and supervisors' attetion compared to real decision about price and production. Second, relying on only accrual manipulation can cause the risk.

Based on research done by Roychowdhury (2006); Cohen et al. (2008); Cohen and Zarowin (2010); Badertscher (2011); and Zang (2012); Kim et al. (2012), this research will use a combination of the three measures of real activities manipulation to detect real activities manipulation. Combined real activities manipulation is built from : (1) the level of abnormal operating cash flow, (2) abnormal production costs, (3) abnormal discretionary load.

2.2 Previous Research

The relationship between corporate social responsibility and earnings management has been investigated by Prior et al. (2008); Kim et al. (2012); Choi et al. (2013); and Grougiou et al. (2014). Prior et al. (2008) examined the relationship between EM and CSR used income smoothing practices for measuring EM based on discretionary accruals Jones model (1991). Research conducted in 2002 and 2004, using a sample of 593 companies from 26 countries. Prior et al. (2008) found a positive relationship between EM and CSR and combinations EM and CSR practices negatively impact the financial performance of the company.

Kim et al. (2012) separated the sample based on company which applying and not applying CSR. The research focused on the relationship between EM and CSR. EM proxied by three parameters. They are discretionary accruals, real activities manipulation and Accounting and Auditing Enforcement Releases (AAERs). The research showed that there is a negative relationship between CSR and EM with explanation that CSR is significantly associated with real activities manipulation and AAERs.

Choi et al. (2013) examined the relationship between EM and CSR that focuses on the company's long-term commitment to the environment and ownership structure. The research used a sample of 2,042 companies from 2002 to 2008 in Korea. Absolute value of abnormal discretionary accruals from the modified Jones models used to measure earnings quality. This study also examined the relationship between CSR and EM simultaneously through 2SLS analysis. This research concluded that firms report high quality earnings also have better CSR ratings. Managers' incentives to engage in CSR driven by managerial opportun-ism weaken as the fraction of shares held by institutional investors increases.

Grougiou et al. (2014) investigated the relationship between CSR and EM on US Banks through 2SLS analysis. This study used a sample of 116 commercial banks in the USA during 2003 to 2007. LLPs and RSGLs model from Dechow et al. (2010) used as a proxy to measure the EM. The research concluded that there is a positive association between EM and CSR since Bank's managers who manipulate earnings tend to intensify their involvement in CSR activities. High engagement in EM increases engagement in CSR but involmentent in CSR does not determine EM. Summary of previous researches are presented below:

Table 2.6

Summary of Previous Researches

No.	Researcher	Variable		Research Finding
		Dependent	Independent	
1.	Prior et al. (2008)	Corporate Social Responsibilities	Earnings Management Proxies : Jones' model (1991) and Dechow et al. (1995)	There is positive impact of EM practices on CSR. The combination between EM and CSR have a significant negative impact on companies' financial performance.
2.	Kim et al. (2012)	Earnings Management Proxies : modified Jones' model Kothari et al. (2005); Real activities manipulation model Roychowdhury (2006); and Accounting and Auditing Enforcement Releases (AAERs)	Corporate Social Responsibilities	CSR firms are less likely to engage in aggresive earnings management through discretional and real activities manipulation.
3.	Choi et al. (2013)	Corporate Social Responsibilities	Earnings Management modified Jones' model Kothari et al. (2005)	Firms which report high quality earnings also have better CSR ratings.
4.	Grougiou et al. (2014)	Corporate Social Responsibilities; Earnings Management EM proxied with LLPs and RSGLs model Dechow et al. (2010)	Earnings Management; Corporate Social Responsibilities	There is a positive association between EM and CSR. Banks which engage in EM practices are also actively involved in CSR activities. But, the extent of a bank's engagement in CSR activities is not influential in determining a bank's indulgence in EM practices.

2.3 Research Framework

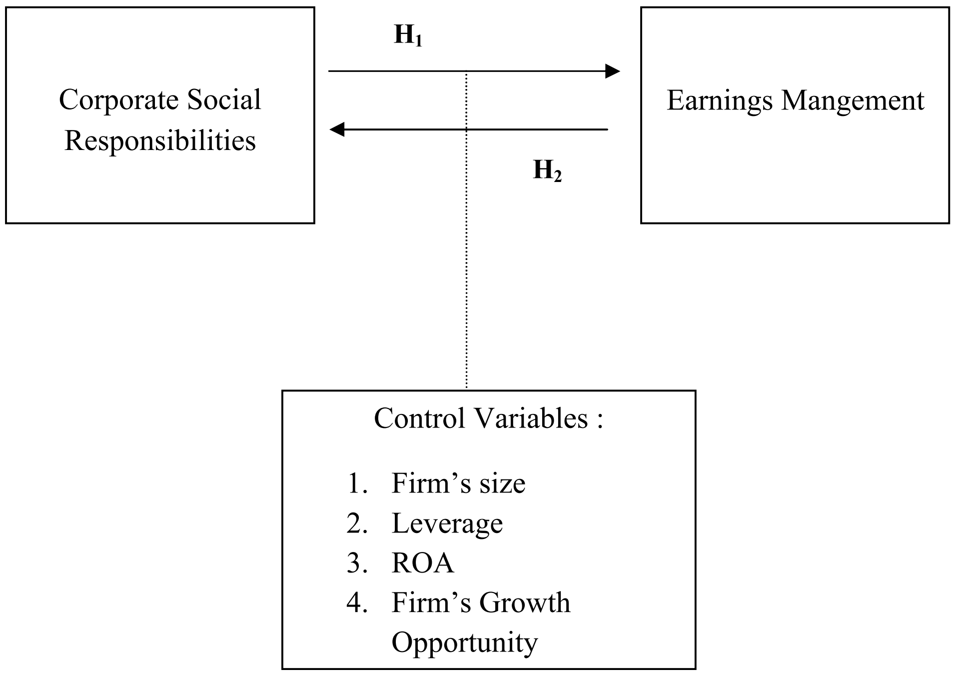
Corporate Social Responsibilty reporting are increasingly viewed prevalent because of the investors' demand, customers and other stakeholders on the more transparent information on the various aspects of the company's business (Kim et al., 2012). On the other hand, according to Hemingway and Maclagan (2004) CSR reporting practices and can be maintained by managers as a means to cover the impact of the corporation badness (cited by Kim at.al, 2012). Managers will tend to mislead its stakeholders regarding the value of the company and financial performance, one of the tools that can be used is the management earnings.

Many previous studies tried to examine the relationship between earnings management and CSR by putting CSR as the dependent variable and earnings management as an independent variable. The study was conducted by Prior et al. (2008) and Hoi et al. (2013). Only few previous studies that try to explore the relationship between CSR and EM where EM and CSR are put as the dependent variable and independent variable at the same time through simultaneity test as been done Choi et al. (2013) and Grougiou et al. (2014).

Based on the issues or facts provided, theoretical studies and previous researches, this study aims to dig deeper relationship between earnings management and CSR reporting by using a two-stages least square (2SLS). Thus, both EM and CSR can be assumed as dependent and independent variable depend on the case. Here is the research framework :

Table 2.7

Research Framework



2.4 Hypothesis Development

Based on the research framework, two hypothesis can be drawn for this research. Those two hypothesis will be explained as follows :

2.4.1 The Effect of CSR Reporting toward Earnings Management Practice

Prior et al. (2012, pp.162) explained that the activities and CSR reporting can be used by the company as a form of social policy implementation mechanism. Furthermore, Prior et al. (2012) explained that participation of stakeholders is essential for the company to do the following things: (1) strengthening the social legitimacy that is received by the company, (2) strengthen the involvement of the board of directors and (3) improve the higher standards performance on the manager.

Kim et al. (2012, pp. 765) mentioned there has been many theoretical studies see CSR from an ethical point of view including Carroll (1979); Donaldson and Preston (1995); Jones (1995); and Phillips et al. (2003) who argued that the moral side is absolutely necessary by the manager to "Do the right thing". Jones (1995) concluded that company that has made a CSR practice will have an incentive to be more honest, trustworthy and ethical. Due to these incentives, the company will eventually limit earnings management practices. So that the first hypothesis can be built is as follows:

H1 : CSR Reporting affects Earnings Management Practice

2.4.2 The Effect of Earnings Management Practice toward CSR Reporting

The emergence of earnings management and CSR reporting practices can be explained by stakeholder-agency theory. The theory explained contractual relationship between stakeholders and agencies implicitly as well as explicitly. Implicitly, the management contract established with one stakeholders namely the owners or stockholders. Explicitly, manager established contracts with other stakeholders such as suppliers, creditors, consumers, and local communities. The stakeholder-agency theory described the claim that different from each stakeholder to be met by the manager. While assuming that market runs inefficient, there are limitations in selecting managers alternative decision. In this case, the power of each stakeholder will affect the decisions to be taken (Hill and Jones, 1992). The Stockholders put a claim against the company for investment funds which has distributed on the company with a maximum rate of return or maximum profit (Hill and Jones, 1992). Prior et al. (2008) mentioned that when company tend to use earnings management as tools to meet the claims of stockholders when declining financial performance is indicated. On the other hand, that these management practices can be covered by either the manager of social activity reporting company or CSR reporting.

Previous research i.e. Fritzche (1991) stated that the code of conduct can be used as window-dressing when managers pursue personal interests or any economic egoism within the organization (cited by Kim et al. (2012)). Hemingway and Maclagan (2004) suggested that companies use CSR to cover impact of companies' badness (cited by Kim et al. (2012)). Companies that undertake CSR reporting may only give an impression to the stakeholders that business and reporting that executable transparent when in fact earnings management hides behind the transparency, especially with their pursuit of the interests of managers with different motives. So the hypothesis that can be built with the background is as follows :

H2 : Earnings Management practice affects CSR Reporting

CHAPTER III
RESEARCH METODOLOGY

This chapter explains the methods which will be used on this research. Variables, population and sample, sample selection, research design, variable measurement will be explained as follow :

3.1 Operational Variable Definition and Measurement

Dependent variable is the primary interest variable to the researcher (Sekaran, 2013). This study use both Earnings Management (EM) and CSR Reporting (CSR_DISC) as the dependent and independent variables. In this study, researcher will test reciprocal relationship between these two variables. There are four control variables in this study. They are the firm size (SIZE), the level of corporate debt (LEV), the firm's profitability (ROA), and the firm's growth opportunities (MTB).

3.1.1 Earnings Management (EM)

Schipper (1989) defines earnings management as an effort to intervene in the process of preparation of external financial reporting in order to gain personal benefits. Proxy used to measure earnings management practice in this study is Real Activity Manipulation which is used on previous research by Roychowdhury (2006), Cohen et al. (2008) dan Kim et al. (2012). Roychowdhury (2006, pp.337) defined real activities manipulation as a deviation from normal operational practice which is driven by the managers' desire to mislead at least some of the stakeholders in order to believe that the purposes of certain financial reporting has been fulfilled in normal operations.

Based on research done by Roychowdhury (2006); Cohen et al. (2008); Cohen and Zarowin (2010); Badertscher (2011); and Zang (2012); Kim et al. (2012), this research will use a combination of the three measures of real activities manipulation to detect real activities manipulation. Combined real activities manipulation is built from : (1) the level of abnormal operating cash flow, (2) abnormal production costs, (3) abnormal discretionary load.

The level of abnormal operating cash flow is measured following Roychowdhury (2006) as follow :

$$CFO_t/A_{t-1} = \alpha_0 + \alpha_1 (1/A_{t-1}) + \beta_1 (S_t/A_{t-1}) + \beta_2 (\Delta S_t/A_{t-1}) + \varepsilon_t \qquad (3.1)$$

where :

CFO_t = firm's operational cashflow on the year *t*

A_{t-1} = firm's total asset on previous year

S_t = firm's net sales on the year *t*

ΔS_t = firm's change in net sales on the year *t*

ε_t = firm's abnormal operational cashflow on the year *t* (AB_CFO)

The second measure to detect real activities manipulation (RAM) is the cost of abnormal production. Previous research of Roychowdury (2006), Cohen et al. (2008), Badertscher (2011) and Zang (2012) defined the cost of production as the sum of the cost of good sold (COGS) and changes in inventories during the year. COGS normal formulation is as follows:

$$COGS_t / A_{t-1} = \alpha_0 + \alpha_1 (1/A_{t-1}) + \beta_1 (S_t/A_{t-1}) + \varepsilon_t \qquad (3.2)$$

where :

$COGS_t$ = cost of goods sold on the year *t*

Normal inventory changes is measured as follows :

$$\Delta INV_t / A_{t-1} = \alpha_0 + \alpha_1 (1/A_{t-1}) + \beta_1 (\Delta S_t/A_{t-1}) + \beta_2 (\Delta S_{t-1}/A_{t-1}) + \varepsilon_t \quad (3.3)$$

where :

ΔINV_t = changes in inventory on the year *t*

Roychowdury (2006), Cohen et al. (2008), Badertscher (2011) and Zang (2012), defined cost of production as the sum of COGSt and ΔINVt. Finally, cost of production can be measured as follows :

$$PROD_t / A_{t-1} = \alpha_0+\alpha_1(1/A_{t-1})+\beta_1(S_t/A_{t-1})+\beta_2(\Delta S_t/A_{t-1})+\beta_3(\Delta S_{t-1}/A_{t-1})+\varepsilon t \quad (3.4)$$

where :

$PROD_t$ = cost of production on the year *t*

ε_t = abnormal production cost (AB_PROD)

The third measure to detect real activities manipulation is abnormal discretionary load. According to Roychowdury (2006), Cohen et al. (2008), Badertscher (2011) and Zang (2012), abnormal discretionary load is measured as follows :

$$DISEXP_t / A_{t-1} = \alpha_0 + \alpha_1(1/A_{t-1}) + \beta_1(S_{t-1}/A_{t-1}) + \varepsilon_t \quad (3.5)$$

where :

$DISEXP_t$ = discretionary load on the year *t* (sum of RnD expenses; advertising expenses; and sales expenses and administration)

ε_t = abnormal discretionary load (AB_DISEXP)

Following Roychowdury (2006) and Kim et al. (2012), this study will use the combination of three measures to detect real manipulation activities as follows :

$$RAM\_PROXY = AB\_CFO - AB\_PROD + AB\_DISEXP \quad (3.6)$$

where :
RAM_PROXY = combined real activities manipulation measures

3.1.2 Corporate Social Responsibility Reporting (CSR_DISC)

According to Gray et al. (1987), CSR reporting is the process of communicating the social and environmental effects of organisations' economic actions to particular interest groups within society and to society at large. CSR reporting on this study will be measured with content analysis. According to Berelson (1952), content analysis is a systematic and objective analytic technique (cited by Kuo and Chen, 2013). Berelson (1952) explained that variables measured in content analysis can be divided into quantitative and qualitative items (cited by Kuo and Chen, 2013).

This study use GRI G3.1 index to cross check the availability of item disclosed in corporation's annual report or sustainability report. GRI G3.1 index has six indicators comprises : (1) environmental; (2) labor practices and decent work; (3) human rights; (4) society; and (5) product responsibility. However, this study only uses five indicators excluding economic indicator. This study exclude economic indicator because this study focused on the social and environment disclosure such as the relationship toward labor or society and the impact toward the sustainability of environment.

The measurement of CSR disclosure (CSR_Disc) uses disclosure occurrence by giving score 1 if the item in G3.1 index is disclosed, and 0 if not disclosed in annual report or sustainability report. Then, CSR_Disc is measured by dividing the number of item disclosed to total items based on indicators used from GRI G3.1 Index. Below is the GRI 3.1 Index used in this study.

Table 3.1

Indicators of GRI 3.1 Index Used in This Study

Indicators	Number of Items
Environment	30
Labor and Decent Work	15
Human Right	11
Society	10
Product Responsibility	9
Total Items	75

3.1.3 Firm Size

Roychowdhury (2006) mentioned that the firm size will potentially significantly affect the variation of earnings management. In addition, according to Prior et al. (2008), the size of the company is also related with CSR performance. Firm size is measured by the market value of equity owned by company. The market value of equity (MVE) is then transformed in the form of logarithms with the purpose to equalize with other variables. This is because the market value of equity (MVE) is relatively larger compared with other variables in this study. Firm size can be calculated as follows:

SIZE = Ln (MVE) (3.7)

3.1.4 Leverage

Leverage in this study was calculated according to the research of Kim et al. (2012) which showed the percentage of the company's assets that are supported by the company's long-term debt financing. So the formula which is used is as follows:

LEV = long-term debt / total assets (3.8)

3.1.5 Return on Asset

Profitability in this study is measured by using Return on Assets (ROA). ROA in this study is estimated according to the reserarch of Kim et al. (2012) as follows:

ROA = profit before extraordinary items / total assets (3.9)

3.1.6 Growth Opportunity

Growth opportunity is a proxy of the firm's future growth opportunities. The firm's growth opportunities in this study is calculated using the market-to-book equity ratio (MTB). Firm's growth opportunity is calculated by the following formula:

MTB = MVE / MBE (3.10)

3.2 Population and Sample

The population in this study is Indonesian listed companies on the Indonesian Stock Exchange (IDX) for the year 2012 and 2013. In this study, samples were selected by purposive sampling method. Sample criterias in this study are as follows:

1. Companies listed in Indonesian Stock Exchange during 2012 and 2013. Companies engaged in the field of finance and banking industry are excluded from the sample because they have the characteristics of assets which are very different from the other industries.
2. Companies that publish annual report and the financial statements as a whole during 2012 and 2013. The companies have complete data availability and in good condition, good availability of data on the corporate social responsibility of companies as well as the data needed to detect earnings management through real activities manipulation.
3. Companies which reported their financial report during 2012 and 2013 under rupiah currency.

3.3 Data Source

The data used in this study is secondary data obtained from the Indonesian Stock Exchange (IDX). Sources of data from this study were drawn from financial statements and annual report during 2012 and 2013.

3.4 Data Collecting Method

Methods used in this study are documentation and literature review method. Documentation method is chosen since the data used in this research is secondary data types. Documentation method done by collecting information and then review the document to solve the reserach problem. The document is in the form of financial statements and annual reports.

Beside, literature review method is also applied. Literature review method is a way of obtaining the data by reading and studying books or literatures relating to the scope of the issues examined in this study.

3.5 Analysis Method

Ghozali (2009) explains that when it is proved that there is simoultant relationship on each equation, two stages least square (2SLS) analysis will give better estimation result which is consistant and efficient than ordinary least squares (OLS). Simoultant relationship occurs because some endogenous regressor variables are correlated with the error or disturbance. Thus, simoultanity test is needed to examine whether endogenous regressor variables are correlated with the error or not. The tests needed before deciding to run 2SLS analysis are Hausman Specification Test and Exogenousity Test.

3.5.1 Hausman Specification Test

Ghozali (2009) explained that the purpose of conducting simoultanity test is to examine whether the dependent (endogenous) variable is correlated with the error or disturbance. Hausman Specification Test is done by using a significance level of 0,10 (α = 10%). Acceptance or rejection of the hypothesis made by criteria as follows:

- If the significance value ≤ 0,10 then Ho is rejected or accept Ha, which means unstandardized residual regression coefficients from reduced form in main equation is significant. This indicates that there is simoultant relationship between two dependent variables.

- If the value of the significance ≥ 0,10 then Ho is accepted and Ha, which means unstandardized residual regression coefficients from reduced form in main equation is not significant. This indicates that there is not simoultant relationship between two dependent variables.

3.5.2 Exogenity Test

Ghozali (2009) explained that the purpose of conducting exogenousity test is to examine whether each variables on each equation should be considered as endogenous or exogenous variables. A reduced form is used to get F value for each equation. F-Test is done by using a significance level of 0.05 (α = 5%). Acceptance or rejection of the hypothesis made by criteria as follows:

- If the significance value ≤ 0.05 then Ho is rejected or accept Ha, which means the model is valid. This indicates that the dependent variables are endogenous.
- If the value of the significance ≥0,05 then Ho is accepted and Ha is rejected, which means that model is not valid. This indicates that the dependent variables are not endogenous and can be considered as exogenous variables.

3.5.3 Two-Stages Least Square (2SLS) Analysis

Two-Stages Least Square (2SLS) analysis is used to test simoultanity between earnings management practice which is proxied with real activities manipulation (RAM_PROXY) and corporate social responsibility reporting (CSR_DISC) as dependent variable with the purpose to find out the reciprocal relationship along with SIZE, LEV, ROA, and MTB as control variables which affect EM and CSR_DISC. Sistematically, the equations for RAM_PROXY and CSR_DISC are formulated as follows :

$$RAM\_PROXY_t = \alpha_0+\alpha_1 CSR\_DISC+\alpha_2 SIZE+\alpha_3 LEV+\alpha_4 ROA+ \varepsilon_1 \quad (3.11)$$

$$CSR\_DISC_t = \beta_0+\beta_1 RAM\_PROXY+\beta_2 SIZE+\beta_5 MTB+ \varepsilon_2 \quad (3.12)$$

Based on two equations above, it can be seen that CSR_DISC and RAM_PROXY are dependent and independent variables at the same time. This condition shows that there is mutual relationship among those two variables.

Ghozali (2009) stated that it is probable that dependent variable will be corellated with the error term in a simoultant equation. In this case, CSR_DISC correlated with ε_2 while RAM_PROXY correlated with $\varepsilon_{1.}$ Thus, an ordinary least square (OLS) regression is potentially to result bias and inconsistent estimation. 2SLS is the correct method to test simoultant equations since all variables will be calculated as a whole as a system.

Before start a 2SLS, every equation has to meet identification criteria. An equation can be categorized as identified if only the equation is stated in unique statistics form and result unique parameter estimation. According to Gujarati (2003), a variable must not be consistent with other equation to meet the criteria. In this case, equation identification can be done by adding or putting out some independent variables into the equation. Identified condition is divided into two groups: exactly identified and over identified.

K-k = m-1 : exactly identied

K-k > m-1 : over-identified

where :

K = number of predetermined independent variable in the model

k = number of predetermined independent variable in the equation

m = number of dependent variable in the equation

Based on eq.3.11 and eq.3.12, it can be drawn :

Endogenous variable = RAM_PROXY and CSR_DISC

Exogenous variable = SIZE, LEV, ROA, MTB

M = CSR_DISC and RAM_PROXY = 2

K = SIZE, LEV, ROA, MTB, α_0, β_0 = 6

Then, it can be concluded that :

(Eq.3.11) (K-k) > (m-1) = (6-3) > (2-1) – overidentified

(Eq.3.12) (K-k) > (m-1) = (6-2) > (2-1) – overidentified

Steps to perform 2SLS Analysis are as follows :

1. Create a reduced form equation from the simoultant equation.

2. The first reduced form equation is resulted by having regression for endogenous variable RAM_PROXY with all exogenous variables in model (SIZE, LEV, ROA, MTB) to get predicted value of RAM_PROXY.

   $RAM\_PROXY_t = c_0+c_1SIZE+ c_2LEV+c_3ROA+c_4MTB + \varepsilon_1$ (3.11a)

3. The second reduced form equation is resulted by having regression for endogenous variable CSR_DISC with all exogenous variables in model (SIZE, LEV, ROA, MTB) to get predicted value of CSR_DISC.

   $CSR\_DISC_t = d_0+d_1SIZE+ d_2LEV+d_3ROA+d_4MTB + \varepsilon_1$ (3.12a)

4. Estimate the initial structural equation by changing the value of predictive CSR_DISC and predictive RAM_PROXY to the equation as predictor. The new equations are as follows :

$$RAM\_PROXY_t = \alpha_0+\alpha_1 PredictedValueof\ CSR\_DISC+\alpha_2SIZE+\alpha_3LEV+\alpha_4ROA+ \varepsilon_1 \quad (3.13)$$

$$CSR\_DISC_t = \beta_0+\beta 1 PredictedValueof\ RAM\_PROXY+\beta_2SIZE+\beta_5MTB+ \varepsilon_2 \quad (3.14)$$

3.5.4 F-Test Statistics

The statistical F-test basically indicates whether all the independent variables included in the model has jointly influence on the dependent variable (Ghozali, 2011, h.98). F-Test is done by using a significance level of 0.05 (α = 5%). Acceptance or rejection of the hypothesis made by criteria as follows:

- If the significance value ≤ 0.05 then Ho is rejected or accept Ha, which means regression coefficients is significant. This indicates that there are relationship which jointly significant between all independent variable on the dependent variable.
- If the value of the significance ≥0,05 then Ho is accepted and Ha is rejected, which means that the regression coefficient is not significant. It is shows that all the independent variables in the model do not have significant effect on the dependent variable.

3.5.5 Significant Test of Individual Parameters (T-Test Statistics)

This test aims to demonstrate how far the influence of the independent variable individually in explaining variation toward dependent variable (Ghozali, 2011, p. 98). The way to perform a t-test is by comparing the value of the t statistic with the critical point by using the table significance level of 5% and the applicable statutes as follows:

- If the significance value ≤ 0.05 then Ho is rejected or accept Ha, then the alternative hypothesis is accepted, that an individual independent variables affect the dependent variable.
- If the value of the significance ≥0,05 then Ho is accepted and Ha is rejected, then the alternative hypothesis is rejected and receive null hypothesis with the implication that the independent variables individual does not affect the dependent variable.

3.5.6 Coefficient of determination Test (R^2)

The coefficient of determination (R^2) essentially measures how far the ability of the model to explain variations in the dependent variable. The coefficient of determination is between zero and one. Small R^2 value means the ability of the independent variables in explaining the variation in the dependent variable is very limited. Approximate value of the means of the independent variables provide almost all the information needed to predict the variation in the dependent variable (Ghozali, 2011, pp. 97).