

An inquiry into the Relationship between Earnings' Management, Corporate Social Responsibility and Corporate Governance

**Sadaf Ehsan
Qaisar Abbas
Ahmad Nawaz**

*Department of Management Sciences, COMSATS University Islamabad,
Lahore*

Abstract

This study investigates the firm's Corporate Social Responsibility (CSR) from the perspective of Earnings' Management (EM) and role of Corporate Governance (CG) in this relationship. Current study adopted a systematic review approach to investigate this overarching idea. Systematic review findings revealed that by and large negative relationship between CSR and EM is more dominant which highlighted the notion that CSR oriented firms are less intended to engage in EM practices. However, evidence of positive relationship between CSR and EM was also provided by some studies and concluded that CSR is used by managers to mask their EM practice. In addition, studies found the significant moderating role of CG between CSR and EM relationship, though evidence was very limited. Moreover, although the research on CSR-EM is very limited, yet it produced mixed results due to the important neglecting factors like lack of sufficient theoretical support, use of different types of EM and varying approaches of measuring CSR. Findings revealed that mostly studies used Accrual type of earnings' management but use of real activities based EM type is very rare. Measuring approaches of CSR also varied across the sample of selected studies. Most of studies used social indices approach to measure CSR and very few followed the content analysis approach especially in developing context.

Keywords: Corporate Social Responsibility, Corporate Governance and Earnings' Management, Systematic Review, Accrual, Real.

The amplified awareness of CSR has resulted in it becoming a buzzword in corporate management and put the business leaders under great pressure to address above mentioned issues and serve the interests of all stakeholders while maximizing their economic performance (Rodriguez-Fernandez, 2016). Much of the existing debate on CSR has typically focused on its relationship with financial performance of firm and voluminous studies tended to show the positive association between them (Kakakhel, Ilyas, Iqbal, & Afeef, 2015; Rehman, Baloch, & Sethi, 2015). However, appearances of recent unprecedented accounting scams and scandals in big giants of the business world like Enron, Xerox, Enron, Anglo Irish Bank, Toshiba etc. have asserted that firm's insiders use their discretions while reporting financial information and mislead outside stakeholders. This process is called Earnings' Management. Healy and Wahlen (1999, p. 6) defined earnings management as: "Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either

mislead some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting numbers.” A great deal of commentary has attributed such accounting scandals to decaying business morality (New York Times, 2002) or to crumbling CSR. The wakes of these issues and events have introduced new perspective of CSR that declared financial transparency and accountability is fundamental for firm’s CSR. Reported accounting information is of primary interest to external stakeholders as their various decisions heavily based on them therefore they should be real and obvious. Given that importance a closer examination of socially responsible behavior of firms is required while reporting their financial information.

There are two perspectives of the relationship between CSR and EM. One is long-term perspective and other one is managerial opportunism. Long-term perspective, under the assumption of stakeholder theory argued that socially responsible firms not only focused on maximizing their short-term profits but they are also inclined to foster healthy and long-term relationships with their stakeholders for long-term performance and sustainable development. Therefore, socially responsible firms are less envisioned to involve in Earnings’ management practices (Cho & Chun, 2015; Choi, Lee, & Park, 2013; Gras-Gil, Manzano, & Fernández, 2016). However, there is another perspective (managerial opportunism) of the CSR- EM relationship according to which managers use CSR as a strategic shield to mask their opportunistic behavior. Firm’s managers and executives sometime put into effect some discretion in working out financial earnings without infringing GAAP (Generally Accepted Accounting Principles) for achieving their personal incentives, thereby affecting reported earnings to come into view either lessor or greater than the original figures (Cohen, Mashruwala, & Zach, 2010).

In order to control the opportunistic behavior of managers to maintain financial integrity in order to provide the more reliable and informative accounting information an effective CG mechanism holds the great importance (Farooq, Ullah, & Kimani, 2015; Lin & Hwang, 2010). Especially after these accounting and management scandals, a strong need has been developed internationally for introducing and implementing effective laws of corporate governance that are able to restrict firm’s executives and managers from exercising their opportunistic incentives in manipulating financial information that have undermined the firm’s financial credibility in stakeholders (Cho & Chun, 2015). One of the fundamental characteristics of CG is to ensure the accountability of firm’s top management to their stakeholders while concurrently providing executives with the autonomy and incentives to exploit wealth producing strategies by making financial reporting system more transparent (Watts and Zimmerman, 1986). Broader view of CG introduced the social viewpoint under which CG is not only meant to

align the interests of managers and shareholders but it should cater the interests of all stakeholders, therefore; CG has a well-defined role in guaranteeing firm's social behavior as well as to provide true accounting information through controlling opportunistic behavior of managers (Larcker, Richardson, & Tuna, 2007).

In this milieu, CSR should be investigated in the perspective of earnings' management to sort out the question 'why companies involve in CSR activities' and whether CG can play an effective role in preventing managers from exercising their opportunistic behavior? In order to fill this gap, present study synthesizes the literature on the CSR, EM and CG that has been done until date to find out major elements of this relationship and identify the consistencies and inconsistencies among various research studies.

This study contributes to the existing literature on CSR and EM relationship in several ways. First, this study adds to the existing literature by providing the detailed review of all the previous studies on the relationship between CSR and EM. Second, it recognized the potential factors that might be the source of inconsistencies in producing results on CSR-EM relationship. Third, it also identified some important research gaps for future research like moderating role of corporate governance and lack of empirical evidence especially in the context of developing economy.

Rest of the paper is mainly categorized in four sections. First section briefly discussed the importance of investigating moderating role of CG between CSR and EM. Second section summarizes the methodology and provides the comprehensive review of the existing literature on the CSR and EM relationship. Third section deals with findings of the review and discussion about the and last fourth section concludes the overall study and recommends some suggestions for future research on CSR and EM relationship.

Moderating role of CG in the relationship between CSR and EM Relationship (A Research Gap)

Managers involved in earnings management practices to achieve their various targets like contractual land compensation arrangements, to relax easy regulatory laws and attract investors (Healy & Wahlen, 1999). In order to overcome the negative consequences of EM, executives and managers of firms actively participate in various activities of CSR to create and attract the public image and market reputation. Prior studies generally agree that a firm with good CG is more successful in preventing managers from exploiting its assets by monitoring the managers' business decisions (Cho & Chun, 2015; Choi et al., 2013). Since CG is a monitoring mechanism that can control the decisions made by managers (Larcker et al., 2007) and restrict the managers' opportunism (Cho & Chun, 2015). A majority of CG-EM studies show that CG plays an important role in constraining EM by monitoring

managers' opportunistic behaviour (Chen, Elder, & Hsieh, 2007; Lin & Hwang, 2010). However, there is a very limited literature that investigates the moderating role CG in the relationship between CSR and EM. Thus, there is need to investigate the influence of CG mechanism on CSR-EM relationship.

Research Methodology

Systematic Review

Systemic review of literature is adopted as a research methodology to explore the association between CSR and EM and moderating role of CG between them. There are lots of studies and researchers that recommend this method of investigating research questions in the field of management studies because it has the ability to satisfy the demands of both communities; practitioner as well as academicians (Javed, Rashid, & Hussain, 2016). This study followed the Brereton, Kitchenham, Budgen, Turner, and Khalil (2007) approach of systematic review.

Data Source

First, several electronic research engines were searched for data collection like Google, Scholar, Science Direct, Springer Link, Wiley Online Library, SAGE Journals, JSTOR Taylor & Francis, Emerald and Palgrave Macmillan. After this, a list of studies and their related journals have been prepared based on research studies that were based on CSR, EM and CG relationship.

Research Questions

1. Is there any sort of a relationship between CSR and EM?
2. What is the nature of relationship between CSR and EM?
3. Is there any moderating role of CG between CSR and EM?
4. Does the type of EM ¹(accrual based or real activities based) matters in CSR and EM relationship?
5. Does the measuring approach of CSR matters in CSR and EM relationship?

¹ In existing literature there are two approaches to measure Earnings' management Accrual and Real. Real earnings management (REM) is defined as: "departures from normal operational practices, motivated by managers' desire to mislead at least some stakeholders into believing certain financial reporting goals have been met in the normal course of operations refers to the companies modifications in the business actions that they take and thus affect their true economic reality" Roychowdhury (2006, p.337). In case of accrual approach of EM, managers exercise their certain degree of discretions over the accrual earnings of firms without violating Generally Accepted Accounting Principles (GAAP) to show either an increase or decrease in the accounting figures (Dechow & Skinner, 2000).

Identification of Relevant Studies

At first level, in order to identify the relevant research studies that addressed the above mention research questions. Relevant studies were selected from the available literature using the main keywords and terms derived from the predefined research questions like corporate social responsibility, corporate social performance, corporate philanthropy, earnings' management, earnings' quality and earnings' manipulation. Finally, thirty five studies were identified that focus on the CSR and EM

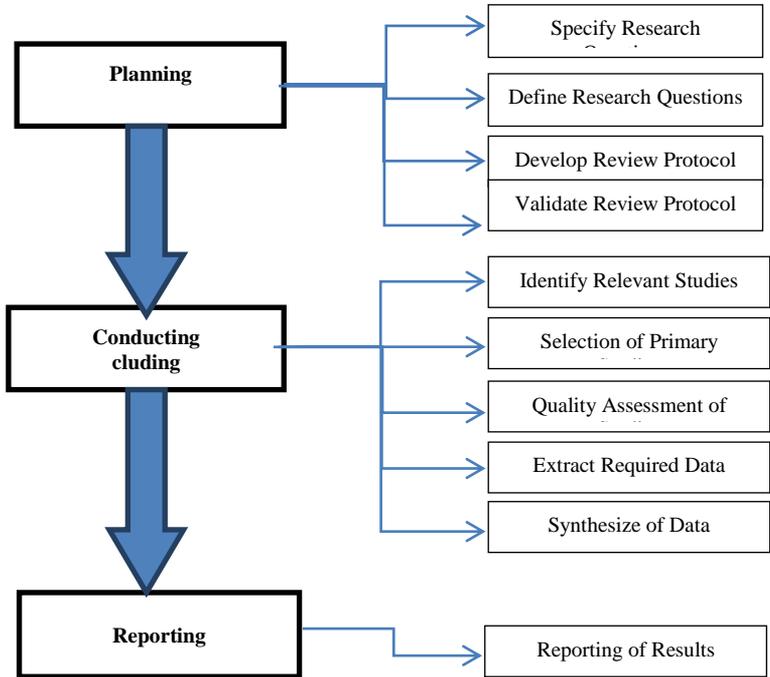


Figure 1. Systematic Review Process adapted from (Brereton et al., 2007)

Protocol of the Review

Developing the protocol of the review is about providing the detail of the planning of the review that has already been discussed and pre-defined in Figure.1.

Selection of Primary Studies

After the identification of relevant studies, a particular criterion was established to select those primary studies that addressed the answers of defined research questions in order to achieve the objective of the research study. In existing study, researchers set three criteria to retain the primary studies. First, it must be a kind of empirical, theoretical, meta-analysis or literature review based study on the relationship between CSR and EM. Second, full text of the study must be

available in English language. Lastly, it should be published in good reputable peer review journal. Implementation of these criteria screened down the forty five studies further and found twenty three studies eligible to be the part of review

Quality Assessment of Studies

This study assessed the quality of each study during the data extraction process on the basis of the four questions. First, does the aim of the study is well explained? Second, does the used research approach in a selected study is properly defined and briefed. Third, does the context of the research is clear? Fourth and last, dose the findings of the research are properly reported and discussed. With respect to these four filters of quality assessment, sample of twenty three studies reduced to sixteen studies.

Data Extraction and Synthesis

For data extraction, first a list of the important parameters from the selected studies has been established. Then based on the mutual discussions of the researchers a final list of parameters was finalized which include; sample of the study, measuring approaches of the CSR, type of the earnings' management and the important findings of each study. After that data has been extracted about these parameters from the selected primary studies and synthesized on a table. A data base was established where all the relevant information regarding the pre-defined research questions and common parameters has been summarized comprehensively to draw the solid inferences about research questions.

Reporting Findings of the Primary Studies

One of the important studies in the context of CSR and EM relationship is Chih, Shen, and Kang (2008) who investigated the impact of CSR related activities on the quality of their earnings under four hypothesis for the large sample of 1,653 corporations selected from 46 countries during the time period 1993-2002. Overall results supported that firms which are actively involved in CSR activities are less intended to involve in smoothing their earnings and not hesitated in reporting their losses or decrease in earnings. Contrary to this, Prior, Surroca, and Tribó (2008) documented the positive relationship between CSR and both kinds of EM i.e. earning aggressiveness and earning smoothing by taking 593 firms from 26 countries over the period of 2002-2004.

In the context of US economies, an empirical study was carried by Laksmana and Yang (2009) to explored the impact of CSR on four earnings' attributes: persistence, quality of accruals, predictability and smoothness. A sample of 652 US public corporation's including 500 Standard and Poor's indexed firms and 152 other firms was used to choose 100 firms that are rated as Best Corporate Citizens (BCC) according to the Business Ethics Magazine ratings based on their CSR

performance information from Kinder Lydenburg and Domini (KLD) for two years 2001 and 2002. The regression results showed that earnings' information of BCC are more desirable as compared to non-BCC.

Calegari, Chotigeat, and Harjoto (2010) tested the two theories of CSR; corporate culture and agent-principal issue while exploring CSR relationship with firm value through the lens of earnings' quality. This study used KLD data for CSR and employed the sample of 3,467 US firms from 1991 to 2008. Results found supporting the evidence that firm's higher indulgence in CSR activities has lower discretionary accruals which increases their earnings' quality and leads to increase in firm's value.

In contrast, Gargouri, Shabou, and Francoeur (2010) investigated the relationship between Corporate Social Performance (CSP) and accrual based EM practices of 109 Canadian firms for two years 2004-2005. Probit analysis results indicated the positive and significant impact of combined CSP and its two dimensions environment and employees on earnings' manipulation. Hong and Andersen (2011) used the sample of only US non-financial firms based on 8,078 observations for ten years from 1995-2005. KLD database is used for taking CSR information of firms. They found that firm's stimulated their accrual based earnings discretions under the support CSR. However, in case of real time activities EM they found negative relationship and argued that CSR considerations drive the firms to reduce EM through manipulating discretionary expenses, production costs and operating cash flows.

Yip, Van Staden, and Cahan (2011) have examined the role of political cost in the relationship between CSR disclosures and accrual EM across two different US industries (oil and gas and food). The results of multivariate regression analysis showed an inverse relationship between CSR and EM in case of oil and gas industry which received high political visibility and pressure especially after 1973 Arab oil crisis and positive relationship in case of food industry which possesses low political scrutiny.

Kim, Park, and Wier (2012) also used KLD data base for CSR and took both measures of EM (accrual and real) and in the context of US economy using a large sample of 18,160 firm-year observation from 1919-2009. Empirical results advocated that CSR reduces earnings' manipulation in both cases: discretionary accruals and real-activities EM as compared to non-CSR firms. In addition, Pyo and Lee (2013) also contended that CSR motivated the firm's to report high quality earnings in Korean firms. Donations and voluntary issuance of CSR reports were used as CSR proxies.

Similarly, Scholtens and Kang (2013) used the earnings' smoothing and earnings' aggressiveness as kinds of EM and supported the inverse relationship between CSR and EM in the context of Asian economies which are characterized by weak economic and legal conditions. This study focused on how EM is associated with CSR and

investor protection for 139 firms from ten Asian countries. Results reported that CSR oriented Asian firms do not appreciate earning management especially in those countries having strong provisions of investor protection.

One important study is Grougiou, Leventis, Dedoulis, and Owusu-Ansah (2014) who not only evaluated the CSR and EM relationship but also explored the direction of causation in this relationship at 116 large US banks from 2003 to 2007. They used KLD data for CSR and loan loss provisions (LLPs) and realized securities gains and losses (RSGLs) were used as proxy for detecting earnings' manipulation of banks which were calculated through (Beatty, Ke, & Petroni, 2002) approach. Results documented that relationship between CSR and EM is positive in nature and unidirectional.

Another important empirical study with reference to US based economy is Gao and Zhang (2015) who used KLD for CSR and earning smoothing for EM. The sample which is used in this study is 2022 firms over the period of 1993-2010. The results of this research indicated that CSR independently reduces earning smoothing and boost financial performance. However, the joint effect of CSR and earning smoothing is positive on earnings information.

In the developing economy, a study was done in Bangladesh by Muttakin, Khan, and Azim (2015). It contained all 135 non-financial firms listed on Dhaka Stock Exchange to explore the impact of CSR commitments on earning management proxy by accrual base earning management over the period of 2005-2009. It is evidenced that executives in developing economy are engaged in earnings manipulation when they make available for higher CSR conducts. These earnings management is attained by income mounting flexible accruals.

Bozzolan, Fabrizi, Mallin, and Michelon (2015) used the sample of 1141 firms selected from 24 countries over the period of 2003-2009. This study is important because they not only examined the role of CSR orientation of firms in reporting earnings' information but also investigated the trade-off between accrual-based type of EM (AEM) and real time EM (REM). CSR variable categorized in three responsibilities namely; community, employee and environmental and their data is collected from Ethical Investment Research and Information Service (EIRIS).

Keeping in view this, Choi et al. (2013) examined the moderating role of business group affiliation and ownership structure in the relationship between CSR and earnings' quality using accrual approach in Korean firms. The sample is based on Korean firm for seven year 2002 to 2008. Results showed that, in case of group affiliated firms and in the presence of concentrated ownership, managers are intended to abuse CSR to conceal their involvement in manipulating accruals EM for their opportunistic behavior. On the other hand, institutional ownership

strengthen the CSR and EM negative relationship because they closely monitor the managerial policies and their activities.

Following Choi et al. (2013) study and their concluding remarks, Cho and Chun (2015) carried out another study using the same sample of Korean firms to investigate the moderating role of CG between real EM and CSR. Their study results proved that the relationship between CSR and real EM is negative. Further, CG negatively moderates this relationship of CSR and EM. They concluded that CG improves the social commitment of firms which leads to decrease the EM practices. However, their CG index based on few attributes of CG mechanism and used only real EM approach.

Results and Discussion

Existence of Relationship between CSR and EM

All selected studies concluded that there is a definite relationship exists between CSR and EM. There is no study that concluded that there is no relationship between CSR and EM. Thus, it is evident that firm's commitment of CSR should also monitor through the lens of EM to monitor the social purpose or objective of the firm.

Nature of Relationship between CSR and EM

Regarding the nature of relationship, results of systematic review were produced mixed evidence and revealed that studies found both positive and negative nature of relationship. There are ten research studies that support the long-term perspective of CSR-EM and stated that firms which are actively involved in CSR activities are less intended to involve in EM practices. However, some studies also found positive nature of relationship between CSR and EM and proved manager exercise their opportunistic behavior by manipulating accounting numbers and therefore; they use CSR as a tool to hide their malpractices and to avoid severe scrutiny of media and stakeholders.

Moderating Role of Corporate Governance between CSR and EM relationship

The studies on the relationship between CSR and EM showed mixed and contradictory results and this might be due to the missing link of CG mechanism. There has been an established literature that CG plays a critical role in enhancing firm's CSR commitment and restricts their EM practices through implanting effective system of monitoring and controlling. There are only two studies (Cho & Chun, 2015; Choi et al., 2013) that investigates the moderating role of CG between CSR and EM relationship and both were done in the context of Korea. However, these studies used the limited attributes of CG and produced mixed results.

Type of the Earnings' Management

Another important factor identified for inconsistent findings in CSR – EM relationship is the type of the EM used. Systematic review indicate that fifteen out of nineteen studies that used accrual based EM like (like Calegari et al., 2010; Gras-Gil et al., 2016; Laksmana & Yang, 2009). Only four studies used the real based EM (Bozzolan et al., 2015; Cho & Chun, 2015; Kim et al., 2012) and three out of these four studies used also used accrual approach of EM. These findings highlights that accrual approach is commonly used but there is little evidence with respect to real EM and there is no study according to the best knowledge of author that investigates the REM and CSR relationship in case of developing country. This finding supports the argument that CSR research is underdeveloped in developing countries as compared to developed ones (Nadeem & Kakakhel, 2012).

Measuring Approaches of CSR

One of the main reasons identified for inconsistent findings of these studies were diversity in the measuring approaches of CSR. As most of the studies were conducted in the developed world economies where firm's CSR data is available and there are established social indices published by social rating agencies. Therefore, use of social indices to measure CSR was prominent. Commonly used social indices include FTSE4Good Global Index KLD, SiRi, MJRA-CSID and KEJI. There was only one study (Muttakin et al., 2015) that found to be done in the context of developing world Bangladesh to explore and it used content analysis approach to measure CSR. One study (Pyo & Lee, 2013) used donation as a proxy for CSR measurement.

Conclusion

Despite CSR being one of the most extensively researched topics in the social research stream, however, why companies involve in CSR activities and spend their capital on them is still tenuous and questionable and this ambiguity might be due to the missing link of EM. Current research adopted a systematic review approach to investigate the CSR and EM relationship and to find out the answer of why companies engage in CSR activities through the lens of EM. The findings of the systematic review revealed that by and large inverse relationship between CSR and EM under the long-term perspective hypothesis is dominant which highlighted the notion that organizations which concerned for establishing healthy relationships with their stakeholders and serve their interests instead of only shareholders are deemed to develop and improve its moral and ethical values which inculcate the aversion against EM practices. However, there are some studies that proved the positive relationship between CSR and EM under the managerial opportunism perspective (Chih et al., 2008; Hong & Andersen, 2011; Prior et al., 2008). Moreover, this study also

investigated the moderating role of CG between CSR and EM and found mixed evidence. Empirical study by Choi et al. (2013) showed both positive and negative moderating role of various attributes of ownership structure on CSR and EM link whereas (Cho & Chun, 2015) study provide the evidence of negative influence of CG on this relationship while using KCGS index.

Review of existing literature on CSR and EM showed that the investigation of firm's engagement in CSR activities through the lens of EM is under explored, therefore; future research studies should investigate this important issue to provide more conclusive remarks on the social behavior of firms. Moreover, one of the surprising findings of the review is the missing link of CG in CSR-EM relationship that should be considered by future studies. Further, results showed that accrual type of EM is more common and very few studies used real EM, therefore; future studies should also consider the real EM type while investigating CSR and EM relationship.

Like all studies, this study also holds certain limitations as well. First, this study is based on the review of the existing studies. To better understand the nexus of CSR, EM and CG, empirical analysis should be done. Second this study does not consider the other variables like financial performance that can influence the CSR-EM relationship.

The findings of this review draw important implications for stakeholders like managers, researchers, investors, and policymakers. Policy making authorities are recommended to reward organizations that pursue CSR initiatives solely for the purpose of social development and at the same time to be vigilant in looking for those organizations that implement CSR initiatives to hide their EM practices. Managers can also use the inferences drawn from this research to execute and formulate the CSR strategies that can assist them to achieve financial transparency when they release and disclose transparent information about their organizations' earnings. Growth has been observed in investments in socially responsible firms. However, the evidence about the positive relationship between CSR and EM gives new insights to shareholders and investors, as it advises them to take caution in analyzing firms' CSR strategies and activities when they make their financial and credit decisions.

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