CSR DISCLOSURE AND EARNINGS MANAGEMENT. EVIDENCE FROM ITALY

Giovanna GAVANA
University of Insubria
71 Via Monte Generoso, 21100 Varese, IT
giovanna.gavana@uninsubria.it

Pietro GOTTARDO
University of Pavia
5 Via San Felice, 27100 Pavia, IT
pietro.gottardo@unipv.it

Anna Maria MOISELLO
University of Pavia
5 Via San Felice, 27100 Pavia, IT
annamaria.moisello@unipv.it

Abstract. *This paper studies how the ultimate controlling owner affects the relation between earnings management practices and the extent of a firm's CSR disclosure. In so doing we analyze a sample of 216 Italian listed firms, comprising family, non-family and state owned companies for the period 2006-2015. Our results suggest a relation between earnings management and CSR disclosure for State-controlled firms as they present the highest extent of CSR disclosure and discretionary accruals.*

Keywords: *CSR disclosure; earnings management; ownership; non-financial returns; stakeholders.*

Introduction

Firms engage in meeting the expectations of their relevant stakeholders in order to ensure the durability of their operations over time. Companies undertake Corporate Social Responsibility (CSR) disclosure with a growing commitment in order to supply a systematic information on its social and environmental behavior (Adam & Frost, 2008). As a matter of fact, not only shareholders and creditors but also other stakeholders call for information on a firm behavior as they are aware of the relevance of environmental and social consequences of business activities (Van der Laan Smith, Adhikari & Tondkar, 2005). Firms may use different strategies in order to demonstrate that their behavior is in accordance with institutionalized norms (Suchman, 1995). They may set their goals and actions in accordance with stakeholders' expectations or shape their perception through communication (Dowling & Pfeffer, 1975). CSR disclosure is perceived as an indicator of a firm's concerns for societal and environmental issues (Chan, Watson & Woodliff, 2014) and society attaches great relevance to firms that provide social and environmental reporting (Fisher, Gunz & McCutcheon, 2001). Therefore, a firm would use disclosure in order to communicate that it takes care of CSR issues or to manipulate the perception of its social and

environmental performance (Ling & Mowen, 2013) and change the public perception of its legitimacy (Deegan, Rankin & Voght, 2000).

Firms are increasingly seeking to reinforce their competitive advantage by the means of social and environmental communication (Hooghiemstra, 2000). The information on CSR activities has a significant effect on consumers' brand valuation and purchase intent (Pomering & Dolnicar, 2009; Zbuchea, 2013). Communication of a firm's social and environmental activities also results in better employee commitment, consumer loyalty, and financial performance (Maignan et al., 1999). Moreover, there is evidence that CSR announcements influence stock prices as they are positively considered by investors (Arya & Zhang, 2009) and companies are more committed in CSR disclosure when they are engaging in equity and bonds issues (Gavana, Gottardo & Moisello, 2017b). Companies may also try to change investor perception of their financial performance, by the means of earning management. Patten and Trompeter (2003) demonstrated that firms in the chemical industry, facing the risk of a more stringent regulation consequent to a chemical accident, tended to lower reported earnings and that firms showing a higher level of environmental disclosure in the pre-event year showed a lower need to manage downward reporting earning, providing evidence of the complementary use of these practices as a response to the increased political pressure. Yip, Van Staden, and Cahan (2011) find a significant relationship between CSR disclosure and earning management pointing out the political environment as a relevant contextual factor. Finally, Sun, Salama, Hussainey, and Habbash (2010) do not find significant evidence that firms engaged in earning management would be more inclined to provide environmental disclosures, in order to reduce the risk that stakeholders suspect the manipulation of earnings.

Empirical research points out that the nature of a firm's ultimate controlling owner - family, non-family and state - influences a company commitment to the prevention of social concerns (Dyer & Whetten, 2006) and the extent of its CSR disclosure (Gavana, Gottardo & Moisello, 2016), resulting in a higher disclosure engagement in state and family than non-family businesses. There is also evidence that a family endowment in the business has a positive effect on earnings quality (Pazzaglia, Mengoli & Sapienza, 2013).

However, to the best of our knowledge, no research has yet studied how the nature of the ultimate controlling owner affects the relation between CRS disclosure and earnings management.

We address this gap analyzing a sample of 216 Italian listed firms for the period 2006-2015 and, building on the Socioemotional wealth framework (Gómez-Mejía, Haynes, Núñez-Nickel, Jacobson & Moyano-Fuentes, 2007), we study the differences between family and non-family businesses (state and non-state controlled). We aim at verifying whether sustainability reporting is used to mask earnings management, that is a device to detract attention from low quality earnings or, on the contrary if sustainability reporting and financial information are viewed as synergic tools so that higher sustainability disclosure comes with higher earnings quality.

We contribute to CSR disclosure/earnings management studies focusing on family firms and to family business literature answering the call for empirical research grounded in the Socioemotional wealth framework. We find that all in all family firms

present a lower earnings quality and a higher extent of CSR disclosure than their non-family counterparts. State-controlled firms show the highest extent of this type of disclosure but they present a higher level of discretionary accruals than non-family firms.

The reminder of the paper is organized as follows: section 1 provides the theoretical framework and the literary review; section 2 describes data and methods; section 3 points out the results and the related discussion; section 4 concludes highlighting limits and venues for further research.

Theoretical framework and literary review

"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." (Healy & Wahlen, 1999, p.368). During the last few decades, literature widely analyzed the motivations underlying a firm's engagement in earnings manipulations but few studies focused on the relation between ownership nature and this practice.

Empirical studies on Chinese firms suggest that privately-owned listed firms are more prone to upward earnings than the state owned counterpart (Ding, Zhang & Zhang, 2007). A number of studies concentrated on privately-owned firms (listed and unlisted) compared family firms with non-family firms using agency theory arguments to explain the differences in their earnings management behavior, reaching non-conclusive results and different conclusions (among others: Wang, 2006, Yang, 2010, Prencipe & Bar-Yosef, 2011, Chi, Hung, Cheng & Lieu, 2015). More recently literature addressed this topic from the Socioemotional wealth perspective (among others: Stockmans, Lybaert & Voordeckers, 2010, Pazzaglia et al., 2013, Achleitner, Günther, Kaserer & Siciliano, 2014, Martin, Campbell & Gomez-Mejia, 2016), which claims that the concern for the preservation of families' non-financial returns is the reference point for family firms behavior and explains the differences in behavior between family and non-family firms and within family companies (Gomez-Mejia et al. 2007, Cruz, Justo & De Castro, 2012). This non-financial goal influences firms' governance mechanisms, management processes (Gomez-Mejia, Cruz, Berrone & De Castro, 2011), strategies (Gomez-Mejia, Makri & Kintana, 2010), risk-taking choices, business venturing (Gomez-Mejia et al., 2007) capital structure (Gottardo & Moisello, 2014, 2016), proactive stakeholder engagement and environmental management (Berrone, Cruz, Gomez-Mejia & Larraza-Kintana, 2010, Cennamo, Berrone, Cruz & Gomez-Mejia, 2012) and CSR disclosure behavior (Gavana, Gottardo & Moisello, 2017a, Gavana et al., 2017b). SEW relates to different non-financial aspects of the business which provides emotional returns to owning families (Gomez-Mejia et al., 2011). The socioemotional wealth is meant as "the stock of affect-related value that a family derives from its controlling position in a particular firm" (Berrone, Cruz & Gomez-Mejia, 2012, p. 259). Several dimensions characterize a family's affective endowment in the company and the different relevance they assume in individual firms results in family businesses' heterogeneity (Gomez-Mejia et al., 2011).

Theoretical literature highlights five main dimensions: family control and influence on the firms, sense of identification with the company, binding social ties, emotional attachment of family members and renewal of family bonds to the firm through future generations (Berrone et al., 2012). Family control, on the one hand, is the necessary condition in order to exert family influence on the business, indirectly, by appointing a professional CEO, or through the direct involvement of the family in business management; on the other hand, it is itself a relevant source of emotional returns for the owning family. Families experience a strong sense of identification with the company, and the family image and the company's one are strictly related. Family firms are particularly concerned with their reputation; they are aware it reflects on family members image as stakeholders see the company as an extension of the owning family (Berrone et al., 2010). Family members' emotional attachment affects not only the ties between family members involved in the business but also the links between the firm, its employees, lenders and the community at large, developing strong social ties (Berrone et al., 2012). This social capital is itself a source of emotional return for the family and family firms behave in order to preserve this source of socioemotional wealth also for future generations (Cennamo et al., 2012). The "renewal of family bonds" dimension attains the company's principal's purpose to pass the business to future generations.

Earning management in family firms

Regarding the effect of family ownership on earnings management, empirical findings are divergent. Wang (2006) finds founding family ownership is negatively associated with the level of abnormal accruals; differently, the study of Yang (2010) reveals that the level of family ownership negatively affects earning quality, providing evidence of the entrenchment of controlling families to minority shareholders. Research also shows that board independence, expressed by the proportion of independent directors on the board and/or by the absence of CEO duality, reduces the magnitude of earnings management, but this effect is less pronounced in family-controlled firms than in non-family controlled firms, in particular when the CEO is a family member. This result supports the view that in family-controlled firms also independent directors are, to some extent, under family control (Jaggi, Leung & Gul, 2009, Prencipe & Bar-Yosef, 2011). There is also evidence from the high tech industry in Taiwan that the level of board independence lowers the propensity to engage in earnings management in family firms, while the effect is reversed in case of CEO duality (Chi et al., 2015).

More recently, research relies on the socioemotional wealth approach (Gómez-Mejia et al., 2007) to explore earnings management practices in family and non-family firms and within family firms. For the purpose of preserving the firm's value to the benefit of future generations and protecting the stock of non-financial values that the family derives from its controlling position, family firms are more prone to decrease earnings by reporting higher negative discretionary accruals and are less inclined to use real earning management than their non-family counterparts (Achleinter et al., 2014). This behavior would allow family firms to pay out lower dividends and turn resources into investments that increase firm's future value, which is also protected from the detrimental effects that real management generates in the long term (Roychowdury, 2006). Other studies, basing on the socioemotional wealth framework, have shed some light within family firms, demonstrating that non-acquired family firms exhibit higher earnings quality relative to acquired family firms, especially when the CEO is a family

member (Pazzaglia et al., 2013). Martin et al. (2016) suggest that a firm's generational stage affects earnings quality as they find that listed family firms leaded by the founder present a lower engagement in earnings manipulation. On the other hand, Stockmans et al. (2010), focusing on private family firms, point out that a firm's generational stage and CEO type, i.e. family or not family, enhance a firm's attitude to resort to earnings management when financial performance decreases in order to preserve the socioemotional wealth from lenders constraints.

Earning management and non-financial disclosure

Research has investigated how a firm's need to reduce political costs can model the relationship between earnings management and non-financial disclosure. Findings reveal that firms facing the risk of a more stringent industry regulation consequent to a specific accident tend to lower reported earnings and that firms showing a higher level of environmental disclosure in the pre-event year show a lower need to manage downward reporting earnings, providing evidence of the complementary use of these practices as a response to the increased political pressure (Patten & Trompeter, 2003).

More generally, the relationship between earnings management and CSR disclosure would be context-specific, because firms in industries that bear higher political costs (i.e. oil and gas industry) exhibit a negative relationship between CSR disclosure and earning management, that is disclosing firms are characterized by higher quality earnings, whilst firms in industries characterized by lower political costs (i.e. firms in the food industry) use CSR disclosure as a substitute for low quality earnings (Yip et al., 2011). According to legitimacy theory arguments, firms engaged in earnings management might be more inclined to provide environmental disclosures in order to induce the perception that they are acting responsibly towards society and environment and reduce the risk that stakeholders closely scrutinize financial information to seek for earnings manipulations, but literature has not found significant statistical evidence supporting this motivation (Sun et al., 2010).

All in all, empirical findings, on the one hand, suggest that the nature of the ultimate controlling owner affects the motivation and the extent of CSR disclosure, on the other hand, they point out that governance characteristics have an influence on a firm's earnings quality. No studies have yet addressed how the nature of the ultimate controlling owner affects the relation between CRS disclosure and earnings management.

In order to contribute to filling this gap we address the following research question:

R.Q.: How does the nature of the ultimate controlling owner affect the relation between CSR disclosure and earnings management?

Data and methods

We collected the data from the stand-alone CSR reports for the Italian non-financial listed firms. The data refer to the period 2006-2015. Each firm/year has a disclosure score that ranges from 0 to 1. We define a family firm as one where a family owns at

least 20% of common shares. A firm is state controlled if the state, or some other public body, owns at least 50% of common shares.

We aim to investigate the relationship between CSR disclosure, controlling shareholders and earning management. To analyze this topic, we take into account accruals and several control variables. We measure financial performance with the return on total assets ratio (Roa). Leverage (Lev) is measured with the book value of the financial debt-to-equity ratio. Sgrowth measures sales growth from t-1 to t. We measure size as the log of total assets. Government and family ownership are likely to affect disclosure. State is a dummy to control if the firm is owned by public bodies. Family is a dummy to control for concentrated ownership.

We assume discretionary accruals as the proxy for earnings management and draw upon the modified Jones model (Dechow, Sloan & Sweeney, 1995) for their estimation. We use the cross-sectional version of the model (DeFond & Subramanyam, 1998, Peasnell, Pope & Young, 2000, Bartov, Gul & Tsui, 2001) and, according to the ATECO industry classification, we group our sample firms in ten classes, retaining the observations only if in each year-class there are at least ten observations. Discretionary accruals (DA) are the difference between total accruals (TA) and non-discretionary accruals (NDA). We compute total accruals through the balance sheet approach (Healy, 1985, Jones, 1991, Bartov et al., 2001, Martin et al., 2016), as stated below:

$$TA_{i,t} = \Delta CA_{i,t} - \Delta CASH_{i,t} - \Delta CL_{i,t} + \Delta STD_{i,t} - DEP_{i,t} \quad [1]$$

where
$TA_{i,t}$ = total accruals
$\Delta CA_{i,t}$ = change in current assets between period *t-1* and *t*
$\Delta CASH_{i,t}$ = change in Cash and cash equivalents between period *t-1* and *t*
$\Delta CL_{i,t}$ = change in Current liabilities between period *t-1* and *t*
$\Delta STD_{i,t}$ = change in short term debts included in current liabilities between period *t-1* and *t*
$DEP_{i,t}$ = depreciation and amortization expenses

The second step is the estimation of non-discretionary accruals, that is the expected component of total accruals. Non-discretionary accruals are estimated using the following model:

$$TA_{i,t}/A_{i,t-1} = \alpha_0(1/A_{i,t-1}) + \alpha_1[(\Delta REV_{i,t} - \Delta REC_{i,t})/A_{i,t-1}] + \alpha_2(PPE_{i,t}/A_{i,t-1}) + \varepsilon_{i,t} \quad [2]$$

where
$A_{i,t-1}$ = lagged total assets
$\Delta REV_{i,t}$ = change in revenues between period *t-1* and *t*
$\Delta REC_{i,t}$ = change in trade receivables between period *t-1* and *t*
$PPE_{i,t}$ = gross property, plant and equipment

Coefficients α_0, α_1, α_2 are estimated by regressing consolidated financial statements values from each firm in the same industry in each period. The industry-year regression coefficients from equation [2] are applied to estimate the non-discretionary accruals for firm *i* in period *t*

$$NDA_{i,t}/A_{i,t-1} = a_0(1/A_{i,t-1}) + a_1[(\Delta REV_{i,t} - \Delta REC_{i,t})/A_{i,t-1}] + a_2(PPE_{i,t}/A_{i,t-1}) \quad [3]$$

Finally, discretionary accruals for firm *i* in period *t* are calculated as the difference between total accruals and non-discretionary accruals (all variables are scaled by lagged total assets)

$$DA_{i,t} = TA_{i,t} - NDA_{i,t}$$

Results and discussion

Table 1 reports descriptive statistics for total and discretionary accruals, disclosure score and control variables for the full sample and the family, non-family and state-controlled subsamples. The disclosure index has a mean value that is lowest for non-family firms (0.05) and highest for the state-controlled firms (0.51), while family firms have a mean disclosure score of 0.09. The ratio of total accruals to lagged assets (TA) is -3.51%, with a small difference in mean values between family and non-family firms and a significantly lower value for state-controlled firms. The ratio of discretionary accruals to lagged assets is on average -0.87%, the higher value is found for family firms, -1.08%, and the lowest for non-family firms, -0.70%. In the period analyzed firm performance (Roa) is high for state-controlled and family firms and low (negative) for non-family firms. Leverage (Lev) is higher for family firms than for non-family or state-controlled firms. In the full sample, family firms represent 51% of the data and state-controlled firms another 8%.

Table 1. Descriptive statistics

	All firms	Family	Non-Family	State-controlled
	Mean Median (STD)	Mean Median (STD)	Mean Median (STD)	Mean Median (STD)
TA	-3.51 -2.65 (24.49)	-3.62 -3.23 (21.37)	-3.64 -2.04 (28.62)	-2.22 -1.54 (18.44)
DA	-0.87 -0.66 (19.39)	-1.08 -0.93 (17.87)	-0.70 -0.14 (21.38)	-0.95 -1.19 (17.75)
Size	12.54 12.46 (1.96)	12.65 12.55 (1.50)	11.85 11.96 (1.90)	15.15 15.59 (2.09)
Sgrowth	14.27 0.92 (93.36)	4.63 0.60 (50.34)	25.70 1.82 (142.4)	24.99 0.61 (144.1)
Lev	0.85 0.36 (4.98)	0.95 0.46 (4.54)	0.79 0.28 (5.86)	0.37 0.31 (0.48)
Roa	1.01 0.54 (12.05)	1.65 0.52 (8.39)	-1.84 0.47 (16.09)	2.00 1.36 (4.29)
CSR	0.11 0.00 (0.27)	0.09 0.00 (0.24)	0.05 0.00 (0.17)	0.51 0.64 (0.40)
Family	0.51 - -	-	-	-
State	0.08 - -	-	-	-

Our research question focuses on the effect of the ultimate controlling owner's nature on the relation between CSR disclosure and earnings management. More specifically if different controlling owners use this type of disclosure with different purposes. CSR disclosure may be used to detract attention from low quality earnings or, on the contrary, CSR disclosure and financial information may reflect together a firm effort to be transparent and to build a faithful relationship with investors and other groups of stakeholders so that higher CSR disclosure comes with higher earnings quality.

Our preliminary analysis does not give evidence of a positive correlation between discretionary accruals and level of disclosure for family firms, as they present the lowest CSR disclosure extent and a lower earnings quality than other firms. These findings suggest that family firms are not likely to resort to CSR disclosure in order to

hide earnings management. As a matter of fact, family firms may be prone to downward earnings in order to retain resources into the firm (Achleinter et al., 2014) because they avoid resorting to non-family equity capital in the future to preserve family control (Gottardo & Moisello, 2014). On the other hand, they may also upward earnings in order to facilitate the relations with lenders and debt financing (Stockmans et al., 2010). Consistently with previous research (Gavana et al., 2017a), our results point out that family firms are not likely to preserve reputation and gain legitimacy by the means of CSR disclosure. State-controlled firms present the highest extent of CSR disclosure, but in mean they present a lower earnings quality than non-family firms suggesting that State-controlled firms are more likely to use CSR disclosure in order to divert attention from their earnings manipulation practices. It is consistent with the observations of Tagesson, Blank, Broberg and Collin (2009, p. 360) pointing out that for cultural reasons state-controlled firms try to demonstrate that they "serve as good examples" therefore they are more prone to mask unethical accounting practices bringing stakeholders attention on their social and environmental commitment.

As a matter of fact, State-owned firms are in mean more visible because of their size and they are more subject to public scrutiny. Therefore, these firms more actively engage in showing that they behave consistently with society's expectations and CSR reporting is a valuable tool for disclosing a firm's socially-responsible behavior. Citizens are the ultimate controlling owner for state-controlled firms. The positive return they derive depend on these firms' social performance (Gavana et al., 2017a) and the negative one consists of the cost they are likely to bear in fiscal terms if these firms do not produce an acceptable financial return. For this reason, social performance disclosure might be an effective means for diverting attention from earnings quality especially when a state controlled firm is lowering earnings, by the means of accounting manipulation, in order to reduce dividends.

Family firms are more committed to CSR disclosure than their non-family counterparts. They are concerned with the business image as it affects the owning family's reputation (Berrone et al. 2012), therefore they are more prone than non-family companies to disclose that they operate consistently with societal values (Berrone et al. 2010, Gavana et al., 2017a). On the other hand, these results suggest that family firms are more prone to lower earnings than non-family firms (Achleinter et al., 2014). This is likely to be due to the strong long term orientation of family firms, related to the desire to pass a healthy business to future generations (Berrone et al., 2012), that might result in reported earnings being managed downward in order to lower dividends or taxes and enhance internal financing. All in all, our findings show that earnings management in family firms is not significantly higher than in state-controlled firms, but the level of CSR disclosure is significantly lower, suggesting that, in mean, family businesses are not likely to use CSR disclosure as a means for hiding earnings management.

Conclusions

This explorative study addresses the issue of the ultimate controlling owner nature effect on the extent of a firm's CSR disclosure, also taking into account its earnings quality, by analyzing a sample of 216 Italian listed firms for the period 2006-2015.

The findings suggest a significant role of the ultimate controlling owner nature in combining or not CSR disclosure with earnings management practices in order to hide the latter by the means of the former. This study has some limitations because it takes into account only the ownership nature without controlling for the effect of management characteristics. Therefore, more research is needed in order to verify the suggestion of this analysis taking into account other governance features which may highlight the possible heterogeneous behavior within firms with the same ultimate controlling owner nature.

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