CHAPTER I

INTRODUCTION

1.1 Background

Financial performance is an important factor for companies, because it can influence decision-making behavior (Fahmi, 2012). Financial performance assessment can be measured based on internal and external assessment standards. Internal standards refer to comparing the company's current performance with the previous period, while external standards refer to competitive benchmarking which is the process of comparing companies with competitors (Wright et al., 1996). Good financial performance helps companies compete (Pratiwi & Sedana, 2017). The results of measuring financial performance are a tool to measure the success of a company in generating profits and are the basis for company management in making decisions to improve performance in the following period (Kristiyanti, 2012).

Corporate Social Responsibility (CSR) is an important non-financial information for companies due to high public expectations of information transparency through non-financial information. Kudłak et al., (2018) state that the increase in CSR activities indicates that more and more business entities are taking responsibility for their business operations. CSR disclosure is associated with improving the company's reputation and competitiveness (Mahrani & Soewarno, 2018). In addition, CSR disclosure helps companies meet the expectations of stakeholders so as to create a company's competitive advantage (Rehman et al. 2020). CSR activities relate to the company's ethical behavior which has a positive impact on the company, namely the company can retain good and trained staff (Rehman et al., 2020) so that it is associated with better financial performance (Akben-Selcuk, 2019).

The results of previous research conducted by Okafor et al., (2021) and Giannarakis et al., (2016) provide evidence that CSR disclosure has a positive and significant effect on revenue growth and profitability of companies in the US. Meanwhile, Ahyani & Puspitasari, (2019) prove that CSR disclosure has a positive and significant effect on financial performance in Indonesia. Furthermore, Nyeadi et al., (2018) provide empirical evidence that CSR has a positive and significant effect on financial performance in South African companies. Finally, Javaid & Al-Malkawi, (2018) found evidence that CSR has a significant positive effect on financial performance in Saudi Arabia. Based on the results of this study, it can be concluded that CSR disclosure improves the company's financial performance. The positive impact of CSR disclosure then encourages companies in industrialized countries such as America and European countries to start measuring, recognizing, and disclosing non-financial information.

On the other hand, there are studies that provide empirical evidence that CSR disclosure has a negative effect on financial performance. Rehman et al., (2020), revealed that there is a negative and significant relationship between CSRD and the financial performance of Islamic banks in Pakistan. Then, research conducted by (Sekhon & Kathuria, 2020) found that the effect of CSR on financial performance proxied by ROE is significantly negative. Magdalena et al., (2017) found that CSR has a negative effect on ROA. These results imply that CSR disclosure can reduce the company's financial performance. According to Friedman (1970) the company's business responsibility is to maximize profits and returns for shareholders. This means that CSR activities are not activities related to profit maximization.

Based on the results of previous studies, it can be concluded that research on the effect of CSR disclosure on financial performance is mixed and inconsistent. The diversity of results is expected because the relationship between CSR disclosure and financial performance is indirect. This means that there are other variables that mediate the relationship. This researcher suspects that earnings management is the variable that mediates the relationship. The underlying argument is that earnings management is the action of a manager that aims to increase or decrease reported earnings (Fischer & Rosenzweig, 1995). Earnings management occurs due to information asymmetry between management (agent) and owners of capital (principal), in which case management is motivated to maximize the fulfillment of their economic and psychological needs, however, they do not convey appropriate information to owners (Jensen & Meckling, 1976).

Agency Theory implies that there is a contract between the principal hiring and delegating authority in decision-making to the agent (Jensen & Meckling, 1976). Basically, agency relationships are problematic if the principal and agent have different interests. The difference in interests between the agent and the principal can result in conflicts of interest and information asymmetry (Messier et al., 2017). Therefore, a control mechanism is needed for the difference in interests between the agent and the principal, through the disclosure of financial and non-financial information. Non-financial information is collected through CSR disclosure.

Legitimacy theory requires a social contract between the company and society to fulfill the company's responsibility to the surrounding environment. In addition, legitimacy theory aims to emphasize that companies take effective actions to prevent and overcome social threats that may be faced by companies if they do not pay attention to the environment (Hamm et al., 2022). CSR disclosure can help companies gain support from the environment and society, so that companies can operate safely.

CSR disclosure is related to the company's financial performance. Prior et al., (2008) state that companies believe that by satisfying investor interests and projecting an image of social and environmental concern and awareness, such actions are believed to have a positive impact on the company's financial performance. In addition, CSR disclosure creates transparent information, by encouraging managers to reduce earnings management practices, thereby maintaining the company's positive relationship with stakeholders (Y. Kim et al., 2012).

Previous research that examines the mediating role of earnings management on the effect of CSR disclosure on company financial performance has been conducted by Mahrani & Soewarno, (2018) and Nurbayani et al., (2021). This study is different from previous research in several ways, first, research conducted by Mahrani & Soewarno, (2018) and Nurbayani et al., (2021) uses two independent variables, namely CSR disclosure and Good Corporate Governance (GCG). The second difference is that the research samples (Mahrani & Soewarno, 2018) and (Nurbayani et al., 2021) are public companies listed on the Indonesian capital market while this study uses public companies in Europe. The reason why researchers chose European countries is first, Europe has a regulation that regulates CSR disclosure, namely The Non-Financial Reporting Directive. Europe adopted the DFRD in 2014, which then requires large companies with more than 500 employees and public interest entities to produce annual corporate reports with information on social, environmental, human rights, and anti-corruption policies, risks, and performance (European Union, 2014). The second reason is that the movement in Europe appears to be more progressive regarding CSR disclosure issues (Tschopp, 2005). And the third reason is because Europe has more sophisticated regulations in CSR disclosure, and has varied priorities on environmental issues such as climate change, environmental preservation, and so on (Tschopp, 2005).

For example, a study conducted in Turkey by Akben-Selcuk, (2019) shows that companies that disclose CSR by considering issues of global warming, draining of natural resources, health security and employment, and ownership concentration have a positive effect on financial performance.

Based on the research gap that has found inconsistent evidence, this study aims to provide empirical evidence that earnings management mediates the effect of CSR disclosure on financial performance.

1.2 Research Question

Based on the background that has been described in the previous section, the problem formulations in this study are:

1. Does CSR disclosure have a positive and significant effect on financial performance?
2. Does CSR disclosure have a positive and significant effect on earnings management?
3. Does earnings management have a negative and significant effect on financial performance?
4. Does earnings management mediate CSR disclosure on financial performance?

1.3 Research Objectives

The objectives of this research are as follows:

1. To provide empirical evidence of the effect of CSR disclosure on financial performance.
2. To provide empirical evidence of the effect of CSR disclosure on earnings management.
3. To provide empirical evidence of the effect of earnings management on financial performance.
4. To provide empirical evidence that earnings management mediates the effect of CSR disclosure on financial performance.

1.4 Research Benefit

The results of this research are expected to provide benefits, among others:

1. For Investors

   This research is expected to provide benefits as an overview, as well as other sources of information in considering aspects for making investment decisions.

2. For Researchers

   This research is expected to be one of the additional references that are useful and can be developed for further research interested in the issue of the relationship between CSR disclosure and financial performance with earnings management as a mediating variable.

1.5 Writing Systematics

The writing of this thesis is presented in 5 chapters, where each chapter will be arranged systematically to illustrate the relationship between one chapter and another, namely:

CHAPTER I: INTRODUCTION

This chapter is an opening chapter that describes the background, problem formulation, research objectives, and research benefits as well as the writing systematic.

CHAPTER II: LITERATURE REVIEW

This chapter describes some basic theories and concepts derived from the literature as well as a discussion of the results of previous studies related to this research. And explain the framework of thought and hypotheses to be tested.

CHAPTER III: RESEARCH METHOD

This chapter contains a description of how the research will be carried out. Therefore, there is a description of research variables, samples, types and sources of data, data collection methods, and analysis methods that will be used.

CHAPTER IV: RESULTS AND DISCUSSION

This chapter describes the results of hypothesis testing, interpretation of results, and justification of research results.

CHAPTER V: CONCLUSION AND SUGGESTION

This chapter presents the final conclusions obtained from the results of the analysis in the previous chapter, as well as suggestions given to various interested parties for the research results.