Jurnal Ekonomi
Volume 13 , Number 01, 2024, DOI 10.54209/ekonomi.v13i01
ESSN 2721-9879 (Online)
https://ejournal.seaninstitute.or.id/index.php/Ekonomi

Environmental, social and governance, and earnings management

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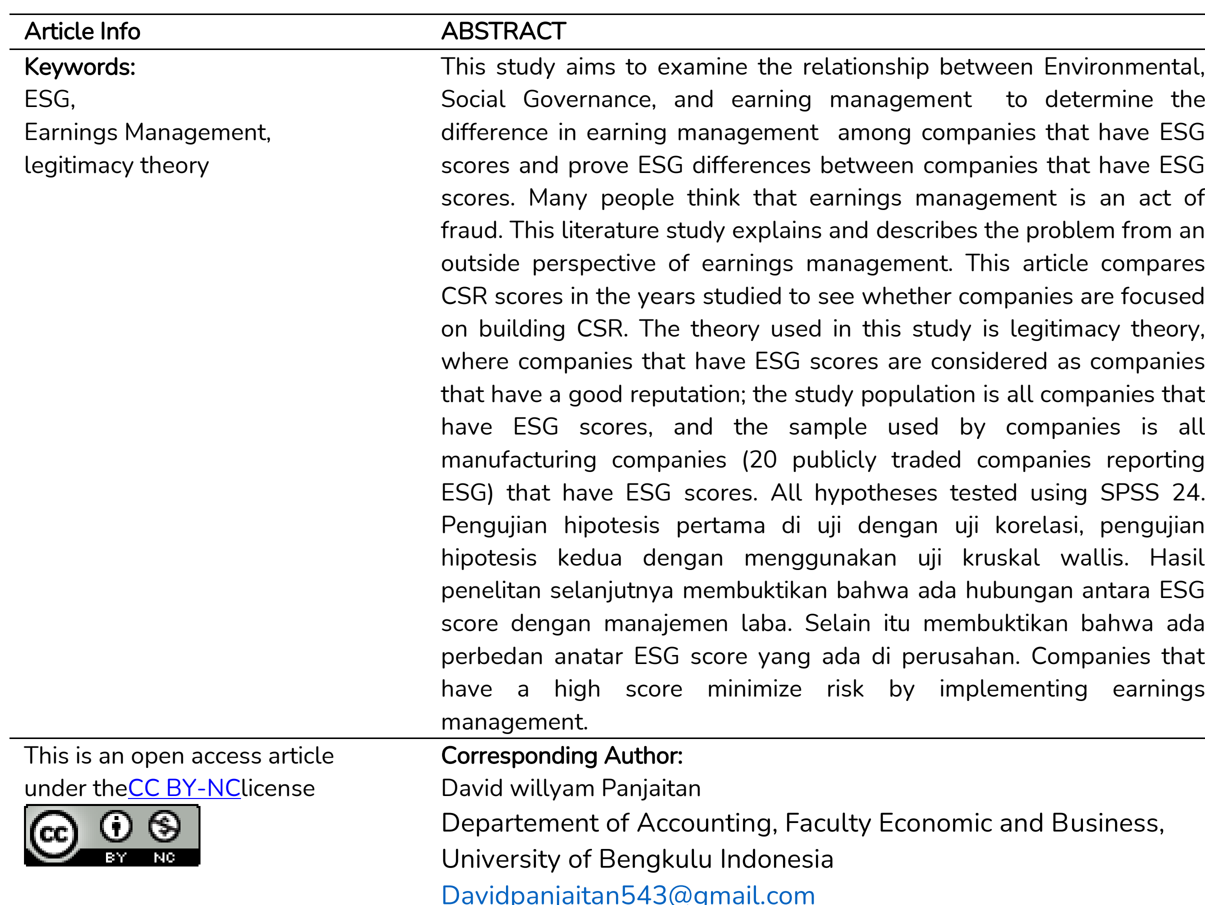

Article Info
Keywords:
ESG,
Earnings Management,
legitimacy theory

ABSTRACT
This study aims to examine the relationship between Environmental, Social Governance, and earning management to determine the difference in earning management among companies that have ESG scores and prove ESG differences between companies that have ESG scores. Many people think that earnings management is an act of fraud. This literature study explains and describes the problem from an outside perspective of earnings management. This article compares CSR scores in the years studied to see whether companies are focused on building CSR. The theory used in this study is legitimacy theory, where companies that have ESG scores are considered as companies that have a good reputation; the study population is all companies that have ESG scores, and the sample used by companies is all manufacturing companies (20 publicly traded companies reporting ESG) that have ESG scores. All hypotheses tested using SPSS 24. Pengujian hipotesis pertama di uji dengan uji korelasi, pengujian hipotesis kedua dengan menggunakan uji kruskal wallis. Hasil penelitan selanjutnya membuktikan bahwa ada hubungan antara ESG score dengan manajemen laba. Selain itu membuktikan bahwa ada perbedan anatar ESG score yang ada di perusahan. Companies that have a high score minimize risk by implementing earnings management.

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INTRODUCTION

In a company, the party responsible for the financial statements is the management because, regarding the processing of financial data in financial reporting in the company, the management deliberately manipulates or engineers financial information to obtain profits [1]. Control often gradually adds or subtracts financial statement data so that the financial statements do not explain the actual information of the condition in the company. Therefore, the financial statements must be described in the basic company information and conditions [2].These events become the basis for management to carry out earning management practices.

The company was established with the primary goal of seeking profit by obtaining maximum profit so that the company's survival can be maintained [3]. But lately, stakeholders demand that companies not only pursue profits but also carry out social

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responsibility. Good companies must carry out social responsibility for the business activities they have carried out [4]. Corporate social responsibility has a philosophy that Corporate social responsibility must have a positive impact on the company and its environment; therefore, producing products must aim positively at society and the environment [5].

The global discourse surrounding environmental degradation has gained prominence since 1962 due to its adverse effects on the natural environment, especially the use of peptides. It is becoming a trigger for increased public awareness of the importance of environmental protection. In 1969, there was an environmental problem, namely oil leakage due to oil drilling operated by Unioin Oil, which triggered environmental degradation that threatened marine ecology, triggering a greater movement on environmental damage. As a result, in 1973, the oil crisis occurred as companies raised prices drastically, resulting in an unavoidable global economic crisis and triggering awareness of options for using environmentally friendly and long-term renewable energy sources. In 1978, there was an industrial disaster: a toxic gas leak from a pesticide plant that caused severe environmental damage and many deaths. The event triggered public attention to corporate responsibility in the social aspects and protection of human rights. Increased attention to environmental and social aspects from year to year has attracted world attention, including the involvement of the United Nations. Although the meaning of ESG was born in 2005, there were some events that occurred before. In 1987, the United Nations Brundtland Commission published a report entitled “Our Common Sense,” also called the Bruntland Report.

This report was published to introduce the concept of sustainable development and how to achieve it. Led by Norwegian Prime Minister Gro Harlem Brundtland, the report explores the causes of environmental degradation in an attempt to understand the relationship between social degeneration, economic growth, environmental issues, and the development of solutions for policies that integrate these three criteria. In 1992, the United Nations convened a conference on environment and development called the "Earth Summit", held in Rio de Janeiro, Brazil. This global conference was organised to commemorate the 20th anniversary of the first environmental congress in Stockholm, Sweden, in 1972. In its organisation, it was concluded that the concept of sustainable development is a goal that can be achieved by all parties around the world, regardless of their status at the local, national, regional, or international levels. In addition, the conference discusses how to integrate the three aspects (environmental, social, and economic) into daily operational activities for human survival and decision-making. In 1999, an international initiative called the United Nations Global Compact was created.

The initiative was intended to merge companies with United Nations agencies, the International Labour Organisation (ILO), or the International Labour and Civil Society rganization. It aims to involve all parties in supporting environmental and social principles universally for a more inclusive and sustainable global economy. In 2000, the Dow Jones Sustainability Index came into being. This measurement technique shows how important sustainable business practices are to generate long-term investment value for their

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investment portfolios. The index is the first measure of sustainability on a global scale and measures the performance of corporate stocks according to the world's leading social, environmental, and economic criteria.

Over the course of time, numerous academics have expressed interest in examining the potential positive and substantial influence of environmental, social, and governance (ESG) factors on operational and financial performance. Additionally, these researchers have sought to investigate if the publication of ESG information has any adverse and significant consequences on market performance [6]

The evaluation of organizations' performance with regards to environmental, social, and governance (ESG) concerns has gained increasing prominence among investors as a mechanism to secure the long-term viability and continuity of firms. Within the framework of a more intricate corporate environment, the management of environmental, social, and governance (ESG) factors is not solely a matter of social obligation, but also holds substantial ramifications for the performance of companies [7] in addition to appealing to investors, companies that exhibit social responsibility are able to attract investment decisions [8]. However, in recent years, the company's financial performance has declined due to the pandemic in 2019. Consequently, the significance of environmental, social, and governance (ESG) factors within corporations is progressively gaining prominence.

According to the IBCSD survey in 2021, the Indonesian Environmental, Social, and Governance (ESG) index currently holds the 36th position among 47 global capital markets. Moreover, it is worth noting that a significant proportion, specifically 40%, of companies operating in Indonesia remain uninformed about the crucial significance of Environmental, Social, and Governance (ESG) factors. Nonetheless, companies are preparing to open up access to large-scale capital in an effort to ensure sustainability, one of the deals being to tackle environmental degradation. It is also to enable the company to increase its competitiveness and attractiveness to investors.

Previous research on differences in environmental, social, and governance (ESG) and earning management scores stated that ESG and earning management scores were the same in several years of research that had been conducted. Companies may engage in earning management to hide the negative impact of a lack of sustainable practices to obtain long-term positive benefits. Previous research on the disclosure of environmental, social, and governance (ESG) in increasing the value of companies has not sufficiently affected the company's value. In the year 2022, a detailed investigation was undertaken to analyze the correlation between Corporate Social Responsibility (CSR) and earnings management. The study revealed a noteworthy impact of CSR on earning management. Specifically, it was observed that discretionary accruals exhibited the highest level of durability compared to other components of the model, regardless of whether the economy was experiencing an expansion or a recession. Furthermore, the study found that the decline in persistence was most pronounced for discretionary accruals when transitioning from an expansionary period to a recessionary one. The difference between this research and previous research in this study is that it uses discretionary accruals and ESG scores, while previous research used CSR and real earning management.

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Literature Review

Theory of legitimacy

The theory that explains the relationship between environmental, social, and governance (ESG) and earning management is the theory of legitimacy[9]. This theoretical perspective underscores the interconnectedness between organisations and society, hence necessitating organisations to be mindful of prevailing social norms. This is due to the fact that community acknowledgement and acceptance can enhance the legitimacy of firms[10]. Legitimacy theory is a theory that agrees on the company's agreement with the community directly or indirectly in carrying out the company's activities, operating and using existing community resources[11]. Thus, this theory has benefits to support the survival of the company. Legitimacy is a system that companies use to align with society, individual governments, and groups of people. According to this theory, the company will survive as long as the community understands that the company runs with the values that exist in society. According to Marek Nagy (2022), there is an influence between ESG and earning management in Visegrad companies. ESG score on. This study explains the relationship of ESG with earning management. This study aims to examine potential disparities in Environmental, Social, and Governance (ESG) scores among manufacturing companies, as well as disparities in earnings management practices within manufacturing companies listed on the IDX (Indonesia Stock Exchange) throughout the period of 2019-2021.

The theory of legitimacy posits that companies may derive benefits or perhaps secure their survival through the acquisition of legitimacy[12]. The legitimacy theory is rooted in social agreements between corporations and society. The survival and growth of a firm depend on its ability to convey its desired goals to distribute benefits, whether economic, social, or political, to the society in which it derives its power[13]. The objective of this study is to investigate potential disparities in Environmental, Social, and Governance (ESG) scores among manufacturing companies, as well as disparities in earnings management practices within manufacturing companies listed on the IDX (Indonesia Stock Exchange) from 2019 to 2021[14].

The theory of legitimacy is stated by giving the idea that there is a difference between values according to the company and those in society[15]. Therefore, the company will be threatened if there is a difference known as the legitimacy gap. The foundation of this philosophy is rooted in the concept that if the community has realized that the company operates in harmony with the community itself, its presence will be able to continue. Insensitivity to the possible impacts that can occur on company activities is stated to cause a legitimacy gap[16]. The legitimacy theory functions as a framework for effectively addressing stakeholders' viewpoints of the imperative nature of attaining organizational legitimacy[17]. Hence, legitimacy confers on an organization the requisite authority to carry out its activities in accordance with the concerns and welfare of its stakeholders.

Legitimacy, in its essence, can be seen as a psychological disposition characterised by individuals and social groups who exhibit heightened sensitivity towards the indicators present in their immediate surroundings. The establishment of community legitimacy is a crucial strategic element for the company's long-term development[18]. This might serve

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as a means to formulate the organization's strategic approach, particularly in regards to endeavours aimed at establishing its presence in a progressively sophisticated society. The community has conferred legitimacy upon the enterprise or organisation based on its qualities, in alignment with the rational and legal framework prevailing within the community [19]. Legitimacy can be conceptualised as a social construct wherein society bestows recognition upon a corporation, or alternatively, as an expectation held by companies towards organisations. Presently, corporations are expected to prioritise not only financial profitability but also demonstrate a commitment to the well-being of the community and the environment. This expectation arises from the recognition that firms derive benefits from the utilisation of resources, and therefore, it is deemed appropriate for them to reinvest a portion of their profits back into the community and the environment. Furthermore, organisations have the potential to enhance their perceived legitimacy within the local community, hence influencing the company's worth in the eyes of investors and the broader society, through the practise of publicising their commitment to social responsibility [20].

The existence of the legitimacy gap is also not something that can be easily assessed. The important thing that the company needs to do is to monitor the company's values to be in line with the surrounding environment so that it can identify opportunities for the emergence of legitimacy gaps. As a legitimate strategy, companies can also adjust their social values and perceptions of the company. So it is necessary for companies to be aware of activities under their control, meet the public or people who have power, and disclose information on CSR activities carried out by the company to the public so that they can provide legitimacy to the company and also be able to avoid the occurrence of legitimacy gaps [21]. This is something that institutional investors pay attention to as investors who tend to invest in the long term. Therefore, institutional investors are very keen to see how a company seeks its legitimacy.

Environmental, social, and governance (ESG)

Environmental, social, and governance (ESG) describes three main aspects of concern that measure a company's sustainability, namely environmental, social and corporate governance. In socially responsible investment (SRI), ESG is considered a reference because it explains the three main components of corporate sustainability: corporate governance, environment, and social [22]. Environmental, social, and governance (ESG) encompasses the relationship between a company and its environment and society, as well as internal control systems and procedures, such as customs, policies, laws, and regulations, among others, to govern the company's entire operations and provide benefits to stakeholders. In sustainability reports, environmental, social, and governance (ESG) aspects are disclosed. GRI defines sustainability reporting as a form of accountability to stakeholders for the company's performance in implementing sustainable development goals. Companies must be able to meet current needs without sacrificing the ability of the next generation to achieve sustainable development goals [23]. Environmental reports can be helpful to some users, such as for companies, it can be used to reveal the performance and impact caused by the company and for investors, it can be used to make investment decisions.

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ESG disclosure assesses a company's performance during ongoing business activities and their impact [24]. environmental, social, and governance (ESG) disclosure can be a superior strategy, especially for companies that can understand and connect with prospects. Thus, companies can have a competitive advantage, especially if others are unaware of risks or opportunities. ESG disclosure has several benefits from various approaches [25]. Cost and risk reduction approaches state that ESG disclosure allows companies to achieve tax incentives or avoid strict regulations to reduce costs. In addition, environmental, social, and governance (ESG) disclosure can reduce the risk of rejection for stakeholders. The legitimacy and reputation approach states that Environmental, social, and governance (ESG) disclosure can meet the needs of competing stakeholders profitably. Competitiveness approach, saying that ESG disclosure can create potential capabilities as a differentiator from their competitors. The synergistic value creation approach states that ESG disclosure can allow companies to meet stakeholder needs by pursuing profit goals.

Furthermore, certain scholars have expressed reservations regarding the intricacy and dependability of environmental, social, and governance (ESG) metrics. However, a significant portion of the criticism stems from the perception that Environmental, Social, and Governance (ESG) criteria exhibit bias against specific sectors, such as the oil and gas industry. Critics contend that fund managers are placing a higher emphasis on political objectives rather than focusing on the generation of financial returns.

Earnings management refers to the deliberate actions undertaken by a manager to manipulate the reported profits of a company under their supervision, with the intention of increasing or decreasing the profits for the present period. This is done without producing a corresponding increase or decrease in the long-term economic benefits of the organization. Earnings management refers to the deliberate actions undertaken by a company's management with the intention of influencing the reported earnings. The process of earning management involves purposeful actions that adhere to the generally accepted accounting principles (GAAP), both inside and beyond the scope of Merchan and Rockness' General Accepted Accounting Principles (GAAP)[26].

Earnings management pertains to the intentional utilization of accounting methodologies by a corporation in order to enhance the appearance of its financial reports. Earnings management may manifest when a corporation experiences pressure to engage in earnings manipulation with the aim of aligning reported results with a predetermined target. The practice of earnings management can have both positive and negative implications. It is generally regarded as beneficial when it is devoid of personal motives. The utilization of these strategies by the firm to artificially boost its profits is seen unfavorable, as it is not sustainable in the long run and may have adverse consequences for the company in the future. Disadvantages of earning management The disadvantage of earning management is low return on assets. Return on assets is the return received from the operating assets of a company. The calculation of return on assets involves the division of net income by the total assets of a company during a specific time frame. Typically, earnings that are conservatively approximated are regarded as more dependable in comparison to those derived from aggressive accounting methods[27]. The quality of

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payments may be compromised as a result of accounting methods that conceal subpar sales or heightened business risk. Fortunately, the field of accounting benefits from the existence of generally accepted accounting principles (GAAP).

Research Hypothesis

Environmental Social Governance or ESG is a standard or guideline used by companies in carrying out sustainable development. The function of ESG is to measure the impact or become a parameter in the development carried out by the company. The ESG score is determined by comparing the quantity of revealed items by the company with the total number of things applicable to the company. This research will see whether there are differences in ESG scores for manufacturing companies in 2019-2021.

H1: there is no difference in Environmental, social, and governance (ESG) scores between companies in the research year

Earnings management refers to the strategic actions undertaken by managers to optimize their own gains or reduce losses in relation to compensation contracts, financial agreements, and political expenses (Octiviany, 2013). Earnings management refers to the deliberate actions taken by management to select accounting procedures within a given framework, with the objective of optimizing the overall welfare or market value of the organization (Widyaningdyah, 2001). This research will also look at whether there are differences in earnings management policies by manufacturing companies in 2019-2021.

H2: there are no differences in profit management policies in companies

METHOD

In this study, a quantitative approach was used, and the type of research used was experimental[28]. This experimental research aims to determine the relationship between Corporate Social Responsibility (CSR) ideas (measured by ESG scores) and earning management behaviour defined based on discretionary accrual levels [29]. Using the modified Jones model, various statistical techniques (correlation analysis, one-way ANOVA, and one-way ANOVA with repeated measurements) were used to ascertain the relationship between CSR and discretionary profit/accrual rates[30]. This is the first Visegrad study to analyze 35 publicly traded companies reporting Environmental, social, and governance (ESG) scores.

RESULT AND DISCUSSION

To find the results of the aim of this research, namely looking for differences between ESG scores and earnings management policies, the author obtained the following explanation:

Differences in ESG scores across companies in the research year

The first hypothesis will look at whether there are differences in ESG scores in manufacturing companies in 2019-2021. Based on Table 1 below, the results tested with the Correlation analysis show no difference in ESG scores in the research year, proven by a significant value of 0.00. in addition, based on the table above, a substantial discount of 0.00 for the ESG score category means no difference in ESG score in the research year. The results show that companies will be more responsible and ethical and have high-quality

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financial reporting (Kliestik et al., 2022). Companies with increased levels of accountability Mitigate risk perception among business partners and other stakeholders, while promoting enhanced economic sustainability and the provision of trustworthy financial information. (Chen & Hung, 2021). Companies with lower Corporate Social Responsibility performance are vulnerable to earning management practices. The primary objective of the organization is to enhance information transparency, foster good engagements with stakeholders, and mitigate the practice of earning management (Ajina et al., 2019).

Table 1. Correlation analysis (ESG Score vs. discretionary accruals)

		Pearson Correlation	Sig. (2-Tailed)
ESG Performance	2020/2019	0.977	0.00
	2021/2020	0.818	0.00

The initial hypothesis examines the potential moderating effect of earning management on the association between environmental, social, and governance (ESG) factors and firm performance. The initial hypothesis examines the potential mediating role of earning management in the association between ESG (Environmental, Social, and Governance) factors and firm performance. In Table 1, there are results that the correlation between ESG scores in the research year is positive in 2020/2019, with a Pearson correlation value of 0.977. Likewise, in 2021/2020, with a Pearson correlation value of 0.818. The first hypothesis is that the difference in ESG is accepted. Companies that do not manipulate revenue will achieve a higher level of Corporate Social Responsibility performance. Therefore, socially responsible companies tend not to drive revenue through discretionary accruals (Ajina et al., 2019). Corporate Social Responsibility activities affect companies in natural earning management, while accrual-based earning management is influential.

Differences in profit management policies in companies

The second hypothesis looks at whether there are differences in earning management policies by manufacturing companies in 2019-2021. ESG can have a significant and relevant influence on company officials when holding the company accountable as a measure of the quality of financial reporting (Tran et al., 2021). Companies that have good ESG work have better reporting quality and will have fewer discretionary accruals and profit levellers (Dimitropoulos, 2022).

Table 2. Kruskal-Wallis test

Null Hypothesis	Test	Sig.	Decision
The distribution of DA is the same across categories of ESG Score level	Independent-Sample Kruskal-Wallis Test	0	Reject the null hypothesis
Variabel	**Bobot**	**Mean**	
Earning Management	Low	-0.0373	
	Medium	-0.0322	
	High	-0.0432	
	Severe	0.0157	

Based on Table 2, the results tested with the Kruskal-Wallis test show the difference in mean menas management policies in the research year are different based on an approach to maximize or minimize profit, proven by a significant value of 0.00. in addition, based on the table above, a substantial discount of 0.00 for the ESG score category means there are differences in ESG scores in the research year. The results show that companies will be more responsible and ethical and have high-quality financial reporting (Kliestik et al., 2022). Companies with more accountability Mitigate risk perception among company partners and other stakeholders, while simultaneously promoting sustainable economic performance and providing reliable financial information (Chen & Hung, 2021). Companies that do worse in CSR are more susceptible to earning management strategies. The organization's goals are to decrease earning management, boost beneficial relationships with stakeholders, and promote information openness (Ajina et al., 2019).

CSR can have a significant and relevant influence on company officials when holding the company accountable as a measure of the quality of financial reporting (Tran et al., 2021). Companies that have good CSR work have better reporting quality and will have fewer discretionary accruals and profit levellers (Dimitropoulos, 2022). Apart from that, the results showed that when the ESG score is in the low category, it will result in a decrease in profits of -0.0373. Companies should have a policy to minimize profit as well as for ESG scores in the medium with a value of -0.0322 and high categories with a value of -0.0432 should approach to reduce gain. However, when the ESG score is at a severe level, profits will increase by 0.0157. This is done so that the company minimizes risks by using the results of legitimacy from the community or, in other words, carrying out more CSR activities to get a higher score. Based on legitimacy theory, it is found that there are differences in earnings management in each environmental, social, and governance (ESG) score used. The better CSR, a company has means that the company is focused on CSR scores or gaining legitimacy and a good image from the community around it.

CONCLUSION

To pay attention to the business world and market players across the globe regarding environmental, social, and governance (ESG). One of the challenges faced by many companies is environmental, social, and governance (ESG), which requires companies to achieve financial goals which play a role in the long-term survival of the company. This study examines the correlation between environmental, social, and governance (ESG) factors and the practice of earnings management within the manufacturing sector. This research also aims to examine potential variations in earnings management practices and environmental, social, and governance (ESG) scores within the manufacturing sector. The research results show that environmental, social, and governance (ESG) performance in manufacturing companies is positively correlated with earnings management. The significance of earnings management calculations is contingent upon the level of environmental, social, and governance (ESG) performance. Moreover, there is no statistically notable variation in earnings management scores among different ESG performance categories. The practical implications of this study are that for companies that

have a high ESG score, it is expected not to do profit management to raise the figure of profit, as long as the company works well. The theoretical implications of this research are to add knowledge related to the relationship between profit management and environmental, social, and government factors for a company. One potential constraint of this study is the limited number of manufacturing companies available for inclusion in the sample. Specifically, only a total of 20 manufacturing companies were identified that satisfied the predetermined criteria and had publicly disclosed Environmental, Social, and Governance (ESG) ratings for three consecutive years (2019-2021), along with all the financial reports needed to calculate earnings management. There are limitations to data collection in this research.

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