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Whether corporate social responsibility is used to suppress earnings management practices and could corporate governance mechanisms prevent them? An empirical study

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Abstract

Purpose – This study examines whether managers adopt corporate social responsibility (CSR) disclosures to suppress earnings management practices and whether corporate governance mechanisms could limit such practices.
Design/methodology/approach – A quantitative approach was followed, in which secondary data from listed firms from 2014 to 2019 were gathered. Descriptive statistics and inferential techniques were performed, which included correlation, ordered logistic regression and 2SLS panel regression analyses.
Findings – The findings indicate that firms use CSR disclosure to conceal managers' opportunistic behaviour via earnings management as an entrenchment strategy and that corporate governance mechanisms could significantly constrain such behaviour.
Research limitations/implications – This study goes beyond the conventional agency theory by incorporating additional theoretical perspectives from stakeholder and legitimacy theories, resulting in a multi-theoretical perspective in conceptualizing the study.
Practical implications – The findings are expected to have significant policy implications, especially in limiting the opportunistic use of CSR disclosures and reducing earnings management practices to safeguard stakeholders' interests and ensure the sustainability of business entities.

Note: Supplementary materials that are included in the article are available online.

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Originality/value – The levels of CSR and board governance practices are captured using comprehensive indices. Moreover, earnings management was operationalized using both accrual-based and real earnings management proxies. Furthermore, while addressing an empirical dearth noted, the findings provide significant policy implications for limiting managers' opportunistic and unethical use of CSR disclosures with corporate governance mechanisms.

Keywords Corporate governance, Corporate social responsibility, Earnings management, Entrenchment strategy, GRI

Paper type Research paper

1. Introduction

Accounting earnings could be considered the most commonly reported performance measure in today's volatile company climate and is critical to stakeholders (Prior *et al.*, 2008). These stakeholders are more concerned with such operational performance, and their role is critical to the organization's survival and existence. They also use financial information to discriminate between the top and worst performing firms and assist them in making financial decisions (Healy and Wahlen, 1999). According to Prior *et al.* (2008) and Tashman *et al.* (2018), management opportunism occurs when managers manipulate earnings to lower or higher levels than in reality without violating the Generally Accepted Accounting Principles (GAAP) to obtain the favour of the stakeholders. Thus, Ghazali *et al.* (2015) suggest that management may be tempted to manage earnings to avoid reporting losses or revealing a decline in reported earnings, demonstrating managerial opportunism. On the other hand, Zhang *et al.* (2020) emphasize that certain firms may make drastic improvements to corporate social responsibility (CSR) disclosure by changing their standalone CSR reports and suppressing earnings management practices. According to Subramanyam (1996), the flexibility of accrual accounting could open doors to managerial discretion and allow them to engage in earnings management. Watts and Zimmerman (1978) define earnings management (EM) as the intervention of managers by controlling accounting information to mislead stakeholders' decisions. Furthermore, Prior *et al.* (2008) argue that rational managers do not engage in earnings management practices if there is no personal gain.

Zahra *et al.* (2005) claim that managers are compelled to conceal the true value of a firm's assets, transactions or financial position, if these can have negative consequences on shareholders, employees, communities within which the firms operate, society at large, and managers' reputation, job security and careers. Because of these adverse effects, Prior *et al.* (2008) highlight that managers may face adverse employee reactions, consumer uncertainty, investor pressure, partner desertions, legal action from regulators, activist boycotts and illegitimacy from the negative community and media exposure. These carry the potential to ruin a firm's reputational capital. Accordingly, researchers argue that due to the aforementioned negative consequences, managers are incentivized to (*mis*)use CSR disclosure as a tactic to counter stakeholders' attention and reactions, which may cost managers' positions and harm the firm's image, which is therefore used as an entrenchment strategy (Prior *et al.*, 2008; Koleva and Meadows, 2021). Especially in emerging economies, a higher tendency for CSR reporting is observed, and the level of CSR disclosure is comparatively higher than in developed countries (Tashman *et al.*, 2018). Moreover, they indicate that multinational enterprises in emerging markets increasingly use CSR reporting as a global legitimization strategy. Thus, it is vital to examine whether CSR activities are exploited to conceal managers' opportunistic behaviour in emerging economies as strict and mandatory regulations are comparatively lower than in developed economies.

CSR is concerned with ethical and moral issues related to corporate decision-making and behaviour, and addresses the complex problems of environmental safeguards, better human resource management, workplace health and safety, local community relations and customer–supplier relationships (Chapple and Moon, 2005). Prior *et al.* (2008) emphasize that CSR activities not only increase stakeholder support but also improve company performance, which is also demonstrated by Dissanayake and Ajward (2019) in an emerging market context. However, using an ethical phenomenon, such as CSR initiatives, for an unethical purpose causes noticeable problems for the firms, which reduces value of these firms in the long term. Hence, a proper control and monitoring system must be established and implemented to minimize conflicts between shareholders and managers. This set of measures is known as corporate governance (Bushman and Smith, 2001) and is defined by the OECD (1999, p. 198) as "the structure of relationships and corresponding responsibilities among a core group consisting of shareholders, board members, and managers designed to best foster the competitive performance required to achieve the corporation's primary goal." Further, Dechow *et al.* (1996) argue that companies use monitoring mechanisms such as corporate governance to align with the interests of stakeholders and managers.

Based on the above observations and arguments, this study examines whether CSR disclosures are misused to cover up and suppress opportunistic earnings management practices and then investigates whether corporate governance practices could reduce such behaviour (i.e. moderate the relationship between CSR disclosure and opportunistic earnings management practices). In addition to these objectives, this study assesses the level of earnings management and CSR practices in an emerging market context.

This study attempted to address several gaps in the literature. One of the main gaps identified in the literature is that many studies (i.e. Prior *et al.,* 2008; Choi *et al.*, 2013; Abbadi *et al.,* 2016) use only a dichotomous measure to capture CSR disclosure (i.e. by assigning 1 for reporting a piece of CSR information and 0 for the absence of such reporting). In contrast, the current study examines how firms comply with the Global Reporting Initiative (GRI) G3 framework utilizing an elaborate structured content analysis with a 0 to 3 scale that better captures the degree of CSR disclosure. This elaborate scoring mechanism is expected to fill a methodological gap noted in previous studies. Another gap identified through the literature review was that many extant studies are restricted to one or a maximum of two theoretical perspectives. In this study, the theoretical framework is strengthened by considering a range of theories, including agency, stakeholder and legitimacy theories, which provides a wider theoretical perspective in operationalizing the construct of CSR disclosure and establishing the conceptual framework of this study. Moreover, contrary to many other studies (i.e. Prior *et al.,* 2008; Choi *et al.,* 2013; Cho and Chun, 2016; Gerged *et al.*, 2020) that used only one approach to measure earnings management, this study uses multiple proxies, namely, accrual-based earnings management and real activity-based earnings management proxies, to operationalize earnings management practices that provide robustness in the analyses performed and conclusions researched thereupon. Furthermore, many studies (i.e. Prior *et al.,* 2008; Choi *et al.*, 2013; Cho and Chun, 2016; Abbadi *et al.*, 2016; Gerged *et al.*, 2020) have not considered the moderating impact of a monitoring mechanism on the relationship between CSR and earnings management. A proper control and monitoring system must be established and implemented to minimize conflicts between shareholders and managers, which discourages the use of CSR by managers to cover up earnings management. In addressing this gap, in the present study, we consider the crucial role of corporate governance by constructing a board index using thirteen vital governance characteristics. The findings of this study are also intended to assist policymakers in limiting the exploitation (or abuse) of CSR disclosure for deviant purposes. Finally, this study seeks to address an empirical gap in international and local contexts concerning the entrenchment strategies of opportunistic managers.

The rest of this paper is structured as follows. The theoretical framework, hypotheses development, the conceptual framework and the methodology employed in this study are all discussed in the following sections. The findings and analysis are then provided, followed by a discussion and conclusions in the final section.

2. Theoretical framework and hypotheses development

Although agency theory implies that managers should act in the best interests of shareholders to reduce agency costs (Fathi, 2013), rational managers may participate in earnings manipulation without private benefits. These intentional management interventions, such as engagement and usage of CSR disclosure, are used to conceal the actual financial position, transactions, assets, or adverse circumstances (Choi *et al.*, 2013; Ghazali *et al.*, 2015). According to Healy and Wahlen (1999), earnings management is a phenomenon in which managers use their discretion in financial reporting in structuring transactions to alter financial reports to either influence contractual outcomes that rely on reported accounting numbers or mislead certain stakeholders about the underlying economic performance of the company. Accordingly, managers could resort to opportunistic and deviant behaviour through financial reporting, mainly through earnings management.

On the other hand, stakeholder theory views CSR as an effective channel for managing stakeholder interactions with firms. Brundtland Report (1987, Sec. 27) indicates that "Humanity has the ability to make development sustainable to ensure that it meets the needs of the present without compromising the ability of future generations to meet their own needs". Votaw (1972) highlights that different opinions and definitions have been attributed to CSR by different scholars who alternatively view CSR as an "obligation" or "legal responsibility" towards society, socially responsible behaviour in an "ethical sense", socially responsible behaviour in a "casual mode", a social conscience, a synonym for "legitimacy", and as a 'fiduciary duty" that requires businesses to behave at a higher standard while contributing charitable contributions to society. Stakeholder theory supports the claim that corporate social responsibility is one of the best tools that lead to more effective use of organizational resources (Prior *et al.*, 2008), and that socially responsible firms are inclined to foster long-term relationships with stakeholders rather than short-term profit maximization (Choi *et al.*, 2013). As a result, a manager who seeks to ensure a company's long-term success must pay close attention to stakeholder needs. Therefore, CSR initiatives may be undertaken to preserve long-term social relationships with stakeholders, including shareholder management. In agreement, Swarnapali (2020) identified that sustainability disclosure affects the firms' earnings informativeness in an emerging market.

Legitimacy theory, on the other hand, could also be utilized to explain the motive of managers in the context of managerial opportunism and offers a foundation for the current study. Lindblom (1994, p. 2) defines "legitimacy" as "a condition or state that arises when an entity's value system is consistent with the wider social system of which the entity is a member." Accordingly, a business continuously strives to appear legitimate in the broader social system, and in the case of a mismatch between the two value systems (i.e. the existence of a legitimacy gap), the entity may conceal its illegitimacy using different techniques. One such technique is to divert the focus of public attention from one area to another. For example, when there are negative impressions about a firm's environmental pollution, its management may actively pursue other business activities, such as charitable contributions or investments in green energy technologies, to improve that firm's dwindling image (Choi *et al.*, 2013).

Therefore, based on the above discussion, it could be argued that a rent-seeking manager may use the same approach to conceal opportunistic activity (Cho and Chun, 2016). As a result, managers have incentives to compensate stakeholders through CSR disclosures to fight against stakeholder activism and vigilance, and if not addressed, it may cost managers their jobs and undermine the firm's reputation. Therefore, the argument made regarding the opportunistic behaviour of usage of CSR disclosure by managers under the agency theory could be further strengthened and explained by the legitimacy theory. Accordingly, we argue that opportunistic managers may use CSR disclosure as an entrenchment strategy. Based on these observations, this study uses three broader theories, i.e. agency, legitimacy, and stakeholder perspectives, which provide theoretical underpinnings in conceptualizing the relationship between CSR disclosure and earnings management.

In terms of the related empirical literature, extant studies found that managers tend to use CSR activities as a defense tactic against stakeholder activism and vigilance, which if not, might cost a manager his or her job and harm the firm's reputation (Prior *et al.*, 2008). Maintaining positive relations with the firm's stakeholders can also minimize the likelihood of the firm's operations being closely reviewed by stakeholders, which increases managers' job security (Cespa and Cestone, 2007). Consequently, they indicate that a CEO who manipulates earnings is incentivized to present a socially favourable image, given that CSR initiatives are a potent instrument for gaining shareholder support. Adopting earnings management techniques reduces the manager's risk of being dismissed due to pressure from irate shareholders or other stakeholders whose interests have been hurt. In such a context, CSR is used as an entrenchment mechanism (Cespa and Cestone, 2007).

The proclivity to report on CSR in accordance with GRI guidelines and the degree of CSR disclosure are lower in emerging economies than in developed economies (Tashman *et al.*, 2018). Moreover, they indicate that multinational enterprises in emerging markets increasingly use CSR reporting as a global legitimation strategy. This may suggest that such activities could be exploited to conceal managers' opportunistic behaviour, where strict and mandatory regulations are comparatively lower in emerging economies than in developed economies. Further, Zhang *et al.* (2020) reveal that CSR disclosure alleviates reputational damage, enhances legitimacy, and plays an insurance-like or value-protection role during crises. Furthermore, Ningsih *et al.* (2021) demonstrated that CSR disclosure might be used to mitigate the negative tone in management discussion and analysis (MD&A) and unfavourable income statements and that overworked CEOs might employ this as a cover-up tactic. In support of this assertion, Doh *et al.* (2016) found that multinational firms in emerging economies have turned to CSR reporting to legitimate themselves before their stakeholders. Accordingly, based on the theoretical and empirical observations discussed in this section, this study establishes and tests the following hypothesis.

H1a. CSR activities are positively associated with managers' opportunistic behaviour via accruals-based earnings management (i.e. ABEM)

H1b. CSR activities are positively associated with managers' opportunistic behaviour via real activity based earnings management (i.e. RAEM)

The unethical use of ethical practices such as CSR activities and disclosure increases the danger of transparency in business information and the loss of stakeholder support. As a result, shareholders must devise a series of safeguards to counteract opportunism and the misconduct of managers who may manipulate accounting information. This series of mechanisms are identified as corporate governance (Bushman and Smith, 2001), which, according to Cadbury Committee (1992, p. 14), is often regarded as the "system through which corporations are directed and managed." In other words, it is the organization's regulatory system for achieving organizational performance by employing resources efficiently and effectively. Several prominent organizations, such as Enron and WorldCom, have failed because of ineffective corporate governance mechanisms and poor quality of financial reporting (De Silva *et al.*, 2017). As an emerging market, in the Sri Lankan context, failures such as Golden Key Credit Card Company, Pramuka Savings and Development Bank, and ETI Finance Ltd. highlight that ineffective corporate governance mechanisms have essentially lead to corporate failures (Sunday Observer, 2021), and also emphasize concerns over poor reporting quality. As a result, most governments and companies make gradual adjustments to corporate governance systems to align with market concerns. These concerns have heightened interest in emerging economies, owing to the aforementioned scenarios and the importance of adopting appropriate corporate governance mechanisms and systems.

Gerged *et al.* (2020) highlight that corporate governance proxies, such as board size and managerial and institutional ownership structures, moderate the relationship between environmental practices and earnings management in Jordanian firms. In other words, their findings indicate that corporate governance mechanisms reduce opportunistic management behaviour through earnings management. Similarly, Mangala and Singla (2021) emphasized that board committees, the degree of independence of audit committees and their size, and joint audits significantly restrain managers from engaging in earnings management in the Indian context. Given these findings, it is essential that a firm requires solid corporate governance mechanisms to monitor and constrain managers' opportunistic behaviour via earnings management (Choi *et al.*, 2013), and discourage the possible *misuse* of corporate social responsibility to conceal such deviant behaviour. Accordingly, the following hypothesis is established and tested in this study.

H2a. Corporate governance mechanisms moderate the association between CSR activities and managers' opportunistic behaviour via accruals-based earnings management. (i.e. ABEM)

H2b. Corporate governance mechanisms moderate the association between CSR activities and managers' opportunistic behaviour via real activity based earnings management. (i.e. RAEM)

The next section describes the approach used to test the hypotheses established above.

3. Methodology

A quantitative approach was used to investigate the impact of CSR on managers' opportunistic behaviour via earnings management. Many studies, such as Choi *et al.* (2013), Prior *et al.* (2008), and other prominent studies, have used a similar approach. All listed firms on the Colombo Stock Exchange were considered the study population and 1,054 firm-years were selected as the sample (refer to Appendix I which is available in supplementary material to article for the sample selection process and the derivation of the sample in detail). Banks, finance companies and insurance companies in the finance sector were excluded due to differences in the structure, which are also subject to high regulations concerning discretionary management practices.

Based on a comprehensive literature review performed in Section 2 above, the conceptual diagram is developed and shown in Figure 1 (available in supplementary material to article).

Information on the operationalization of independent, dependent, moderating, and control variables is provided in Table 1 (available in supplementary material to article).

In performing the data analysis, first data cleaning and screening (i.e. missing data treatment and outlier winsorization) were performed, followed by diagnostic tests such as testing for linearity, normality, multicollinearity, and heteroscedasticity. Finally, descriptive statistics, correlation tests, and multivariate regression analyses were performed to achieve the research objectives. The following multivariate regression model was applied in the study:

$$CSR_{i,t} = \propto + \infty_1 EM_{i,t} + \infty_2 CG_{i,t} + \infty_3 EM_{i,t} \times CG_{i,t} + \infty_4 GROW_{i,t} + \infty_5 FS_{i,t} + \infty_6 ROA_{i,t} + \infty_7 AQ_{i,t} + \infty_8 LEV_{i,t} + \infty_9 FA_{i,t} + \infty_{10} FO_{i,t} + \infty_{11} IO_{i,t} + \varepsilon_{i,t}$$

The definitions and operationalizations of these variables are provided in Table 1.

4. Analysis and results

This section presents the results obtained for the descriptive analysis, correlation analysis, and 2SLS regression analyses.

Table 2 (available in supplementary material to article) depicts the overall average value of discretionary accruals ($ABEM_{i,t}$), which is 0.095 and the median value is 0.07, while the standard deviation of this is 0.079. The results indicate that there are no significant variations. On the other hand, the overall average value of real earnings management ($RAEM_{i,t}$) is 8.99 and ranges between 0.972 and 14.299, whereas the standard deviation is 0.443. The results again suggest that there are no significant variations. The overall average value of CSR is noted to be 0.352, and the median value was 0.072, and the values of this variable ranged from 0.250 to 1.329, and there is a significant variation noted [1]. Furthermore, based on the median value of CSR, a quite lower tendency of Sri Lankan companies to disclose CSR activities is observed. The corporate governance index has an average value of 0.505 for 179 non-financial companies from 2014 to 2019, ranging from 0.250 to 0.750. Thus, on average, companies complied with 50.5% of corporate governance requirements in Sri Lanka.

The main research objective of this study is to investigate the impact of CSR on managers' opportunistic behaviour via earnings management. Accordingly, The correlation analysis (see Table 3, which is available in supplementary material to article) showed the relationship between the selected variables of the study. The correlation coefficient between $ABEM_{i,t}$ and $CSR_{i,t}$ depicts a significant ($p < 0.05$) positive relationship and supports H1a, which claims that CSR activities are *positively* associated with managers' opportunistic behaviour via earnings management. Further, results show that there is a significant ($p < 0.05$) positive relationship between $RAEM_{i,t}$ and $CSR_{i,t}$ which also supports H1b. Further, there is a significant ($p < 0.05$) association between $CSR_{i,t}$ and audit quality ($AQ_{i,t}$), corporate governance ($CG_{i,t}$), firm size ($FS_{i,t}$), financial performance ($ROA_{i,t}$) and foreign ownership ($FO_{i,t}$).

In our OLS regression analysis, we identified that CSR is used to suppress earnings management practices (not tabulated). However, this relation may suffer from a possible endogeneity issue. Accordingly, to resolve this issue of possible endogeneity in the relationship between CSR and earnings management, we adopt the 2SLS approach. We used stock issuance ($STOCKISSUE_{i,t}$) as the instrumental variable (IV) to deal with such potential endogeneity issues due to the omitted variable bias (Thai, 2014; Dang *et al.*, 2017). Thai (2014) and Dang *et al.* (2017) argued that Stock issuance is used to assess listed firms' future financial performance and profitability. Investors typically invest their funds into profitable and prosperous companies. Profit, according to the stock valuation model, is one of the most deterministic factors of value in the stock market. As a result, listed companies have a tendency to overstate profits during critical periods for increasing stock market value. Dang *et al.* (2017) argue that a large number of publicly listed firms engage in earnings management practices before issuing more stocks in raising additional capital, and thereby to increase stock prices. Following Dang *et al.* (2017), we also consider stock issuance as the instrumental variable and measure it (i.e $STOCKISSUE_{i,t}$) as 1 if issuing stocks in the particular financial year and 0 if otherwise. Accordingly, we performed a two-stage instrumental variable regression analysis and report the results in Table 4 (which is available in supplementary material to article) (we only report the results of the second step due to parsimony [2]). The results of the first step (not tabulated) show significant coefficients for $STOCKISSUE_{i,t}$, demonstrating that it is a valid instrumental variable. Further, Anderson's statistic for the under-identification test and the Sargan statistic for the over-identification test results indicated that this instrumental variable in all models is well specified and that the 2SLS estimators are superior to the OLS estimators (not tabulated) (Larcker and Rusticus, 2010) in all models. After controlling for endogeneity, the 2SLS panel regression analysis results in Table 4 (columns (1)–(4)) display that the predicted values (i.e. *ABEM_PRED* and *RAEM_PRED)* obtained for *ABEM* and *RAEM* illustrate significant positive associations with CSR, respectively. Accordingly, the results in Table 4 show that H1a and H1b of this study are supported, which claims that CSR activities are positively associated with managers' opportunistic behaviour via earnings management. However, the results also show that corporate governance mechanisms significantly negatively moderate this relationship between managers' opportunistic behaviour via earnings management and CSR disclosure under two proxies, which supports H2a and H2b. Overall, this analysis shows that the relationship between earnings management and CSR as well as the moderating effect of corporate governance between them are consistent after controlling for endogeneity issues.

5. Discussion and conclusions

This study investigates whether corporate social responsibility (CSR) disclosure is being (*mis*)used as a method to suppress and cover up the opportunistic behaviour of managers via earnings management practices in an emerging economy by utilizing firms listed on the Colombo Stock Exchange from 2014 to 2019. In addition, earnings management and CSR levels were evaluated as secondary objectives. The findings indicate a low level of accrual-based earnings management ($ABEM_{i,t}$) (mean: 0.095). Similarly, De Silva *et al.* (2017) also found a mean value of 0.077 as the level of discretionary accruals-based earnings management using a sample of manufacturing companies, which is consistent with our findings. Furthermore, Abbadi *et al.* (2016) found that discretionary accruals amounted to 0.097 in a selection of Jordanian firms. Moreover, Choi *et al.* (2013) identified a 0.060 level of accrual-based earnings management in Korean firms, which is again consistent with the findings of this study. However, Goncalves *et al.* (2022) identified that accrual-based earnings management is 0.128 in the European context. According to Zabri *et al.* (2016), publicly traded firms in Malaysia have a comparably greater degree of accrual-based earnings management, with a mean value of 0.165, which is relatively high. On the contrary, the lower value observed in this study in the Sri Lankan context could be attributed to the fact that local firms are subject to a higher level of regulatory scrutiny, and that the majority of the firms' financial statements are audited by Big-4 audit firms, which limits managers' discretion and lowers the degree of accrual-based earnings management in the Sri Lankan context (Dissanayake and Ajward, 2019). However, this study's findings indicate that earnings manipulation in terms of real activities ($RAEM_{i,t}$) is 8.999 (mean). However, contrary to this finding, a relatively lower level (mean value of 0.016) of RAEM is observed in the Malaysian context (Rahman *et al.*, 2019). Consistent with this finding, Owusu *et al.* (2020) reported a mean value of 0.068 RAEM among UK firms, which they attributed to the higher commitment and devotion of UK firms to their sustainable future performance to satisfy their stakeholders. In contrast, the greater level of RAEM observed in the Sri Lankan setting, as revealed in this study, might be interpreted as a result of most Sri Lankan firms having a short-term emphasis and not taking a long-term view owing to the concentration of ownership (i.e. the presence of family-owned businesses). It should be noted that even though RAEM enables managers to meet short-term earnings targets, such manipulations are unlikely to increase long-term firm value, mainly because manipulations via real activities usually negatively impact future cash flows (Rahman *et al.*, 2019). Further, the findings of Choi *et al.* (2013) support the idea that the firm value of an entity could deteriorate over time as a consequence of RAEM.

In terms of the level of CSR in Sri Lanka, the findings of this study indicate a level of 0.072 (median), which is observed to be low and is consistent with the findings of Dissanayake *et al.* (2021). This lower degree of CSR disclosure in Sri Lankan firms could be again attributed to concentrated ownership (family-owned businesses) that does not require providing such information to a wide range of stakeholders or engaging in philanthropic activities (Wijesinghe, 2012). Moreover, Rathnasiri (2003) argues that Sri Lankan firms may not understand social responsibility and that CSR may not be a popular topic. Furthermore, it should be noted that CSR reporting is not mandatory in the Sri Lankan context; therefore, most companies might not pay considerable attention to it (Shamil *et al.*, 2014). Similarly, Mahmood *et al.* (2018) found that only 0.330 of listed companies in Pakistan issued sustainability reports based on the GRI framework. Furthermore, Muttakin *et al.* (2015) indicate that only 0.223 of 116 listed companies in Bangladesh disclose CSR. Thus, based on these findings, it is apparent that the level of CSR in emerging economies is low and that Sri Lankan firms maintain a comparatively lower degree of CSR reporting than Pakistani and Bangladeshi firms.

The correlation and 2SLS regression results show that CSR disclosure is misused (abused) to conceal the adverse outcomes of earnings manipulation to manage stakeholders' expectations, as indicated by the positive association between CSR and real activity-based earnings management. This finding backs up the hypothesis that opportunistic managers utilize CSR as an entrenchment technique to defend their positions. Consistent with this finding, Pagano and Volpin (2005) and Prior *et al.* (2008) suggest that managers who misrepresent earnings information for private gains may participate in CSR activities to safeguard their positions. Moreover, Tashman *et al.* (2018) note that developing market MNEs employ CSR reporting as a worldwide legitimation tactic. Zhang *et al.* (2020) also argue that CSR reporting reduces reputational harm and protects value during crises.

The findings also support that corporate governance mechanisms could weaken the relationship between earnings management and CSR. Consistent with this finding, extant studies indicate that corporate governance mechanisms limit managers' opportunistic behaviour using CSR (Cho and Chun, 2016). Similarly, Gerged *et al.* (2020) found that Jordanian firms' corporate governance mechanisms limit earnings manipulation. They also emphasize the importance of internal corporate governance processes in explaining the relationship between corporate environmental rhetoric and earnings manipulation in developing economies. Consistent with this finding, Mangala and Singla (2021) note that effective board committees, independent audit committees, larger sizes, and joint audits curtail earnings management in the Indian context. Accordingly, these findings provide empirical evidence to support the claim that corporate governance mechanisms constrain earnings management, as found in this study.

5.1 Implications

These findings demonstrate that several key theoretical foundations support the study's theoretical framework, including agency, stakeholders, and legitimacy theories. As a result, the study discovered that corporate social responsibility initiatives (stakeholder theory) might be used to conceal and legitimate (legitimacy theory) managers' opportunistic behaviour (agency theory). Furthermore, in terms of empirical implications, this study addresses an empirical vacuum in examining the moderating influence of corporate governance procedures, which is also found to be effective in reducing opportunistic management behaviour. Moreover, composite indices were utilized in this study to assess corporate social responsibility and corporate governance. Such composite measures provide more reliable results than narrow operationalizations and measures for such constructs, filling again an empirical dearth. In addition, this study fills an empirical gap in an emerging market context by using alternative proxies to assess earnings management (i.e. accrual-based earnings management and real activitybased earnings management in the measurement of earnings management), whereas previous studies mostly used only one dimension.

Furthermore, the findings of this study are expected to have significant policy implications in both emerging and similar market contexts. Accordingly, regulators and government agencies should monitor and supervise firms' use of CSR disclosures to ensure that they are not misused or exploited to compensate for management opportunism. As a result, policymakers and regulators should not assume that companies with higher CSR would always operate ethically to the advantage of stakeholders and may employ such as a cover-up of their opportunistic behaviour. Furthermore, legislators and regulators should strengthen the corporate governance compliance of firms, as this study's findings suggest that corporate governance systems can limit the misuse/abuse of CSR to mask managers' opportunism. Accordingly, establishing a board sub-committee with independent directors with relevant expertise responsible for monitoring CSR activities is a timely move. The study's findings also suggest that corporate executives should limit their opportunistic behaviour to maintain their legitimacy before stakeholders, safeguarding their management positions and sustaining the long-term value of the enterprises they manage. Additionally, because the findings of this study reveal a low level of CSR disclosure in emerging markets, policymakers and regulators should focus on enhancing the level of CSR of firms to obtain a competitive edge. Furthermore, these findings emphasize the necessity for mandatory rules on CSR activities and disclosures relating to the environment, employees, consumers, communities, and other stakeholders to be ethically utilized to benefit all stakeholders.

5.2 Limitations and future research directions

Certain limitations to this study must be considered when evaluating the findings. This research aimed at non-financial firms listed on the Colombo Stock Exchange, and future studies may widen the scope to include banking, finance and insurance companies, as well as firms of other countries for comparative analysis. Moreover, this study used the modified Jones model by Dechow *et al.* (1995) to capture accrual-based earnings management. As a future research direction, alternative proxies that are available (such as Dechow and Dichev (2002), McNichols (2002), Kothari *et al.*'s Performance-Matched (2005) models) could be used. Furthermore, other moderating and mediating variables could be employed to investigate the association between CSR disclosure and opportunistic management behaviour.

Notes

1. Due to the significant variation observed in the level of CSR, the study relied on the "Median" value rather than the "Mean", and thus interpretations and discussions are performed based on the Median value.
2. The results of the first step are available upon request.

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Supplementary material

The supplementary material for this article can be found online.

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