

Corporate Social Responsibility,
Investor Protection, and Earnings Management
–An International Evidence

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To many, recent allegations of accounting fraud (or earnings management; EM) at Enron, coupled with similar ones at many other corporations, are a strong indication of a serious decay in business ethics or CSR.

– New York Times (2002)

So this raises my concern between earnings management (EM) and corporate social responsibility (CSR).

But is it straightforward that...

when a firm cares more about CSR,
it will engage in less EM?

More CSR, Less EM?

Are CSR and EM are negatively related?

In this paper...

we think CSR and EM may also
be *positively related* or *irrelevant*.

(Why?)

What's CSR?

Businesses should not merely be geared toward profits at the expenses of fulfilling their responsibilities to employees, *outsider*, the society, the environment, and so on.

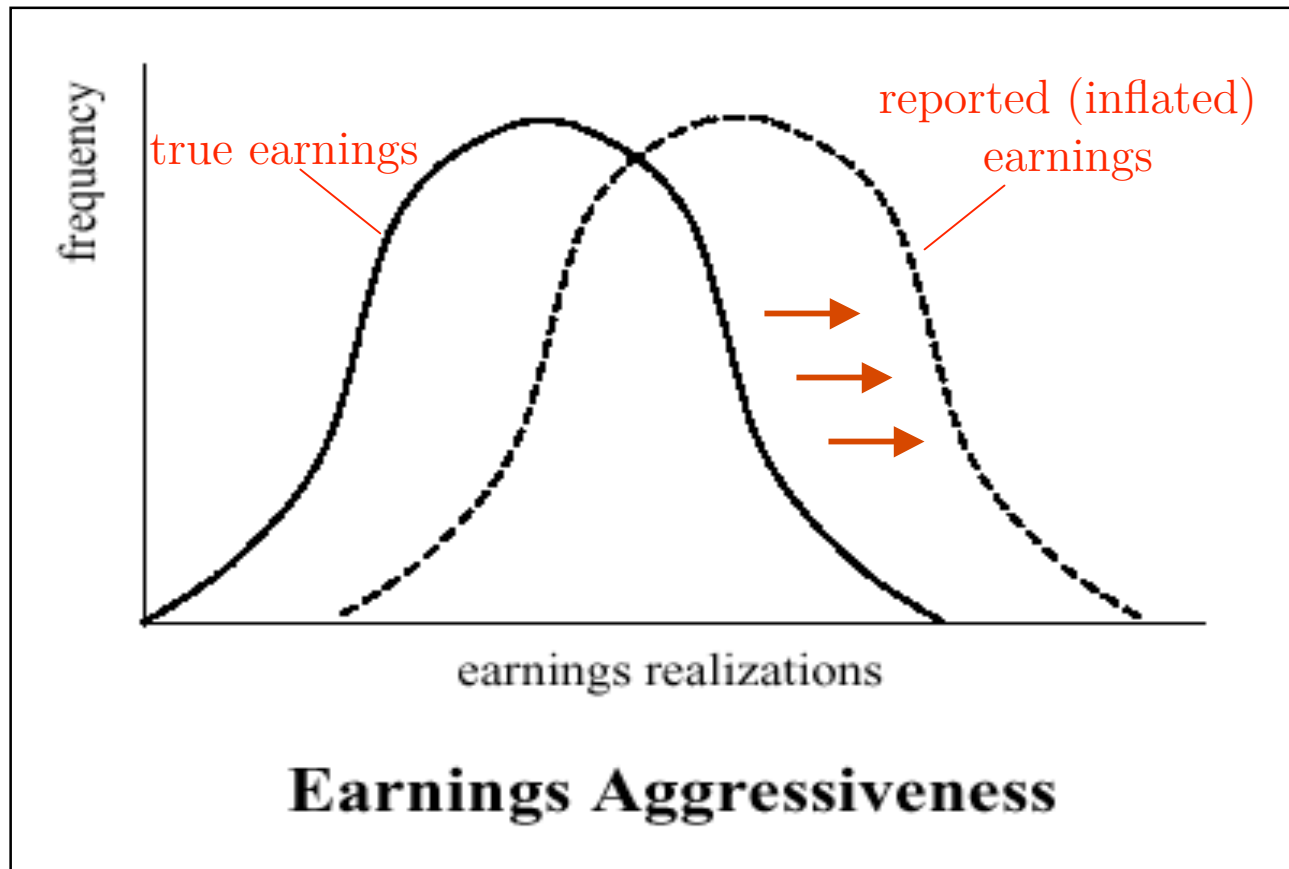
What's EM (earnings management)?

Insiders use their discretion in financial reporting to overstate the true level of earnings and understate any real unfavorable earnings, to weaken outsiders' ability to govern that firm.

–Leuz Nanda, and Wysocki (2003)

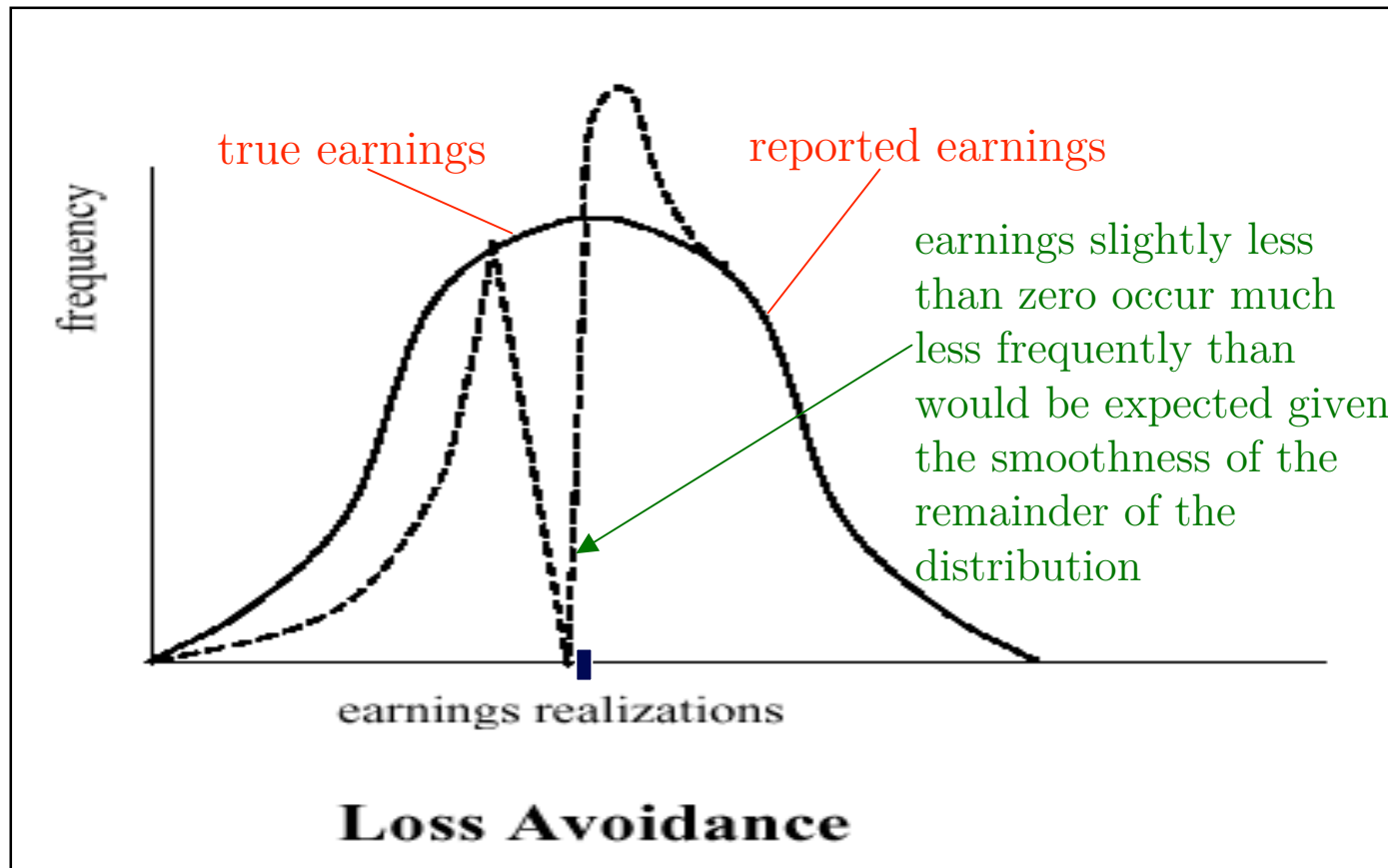
Three kinds of EM are studied:

- earnings smoothing
- earnings aggressiveness
- earnings losses and decreases avoidance



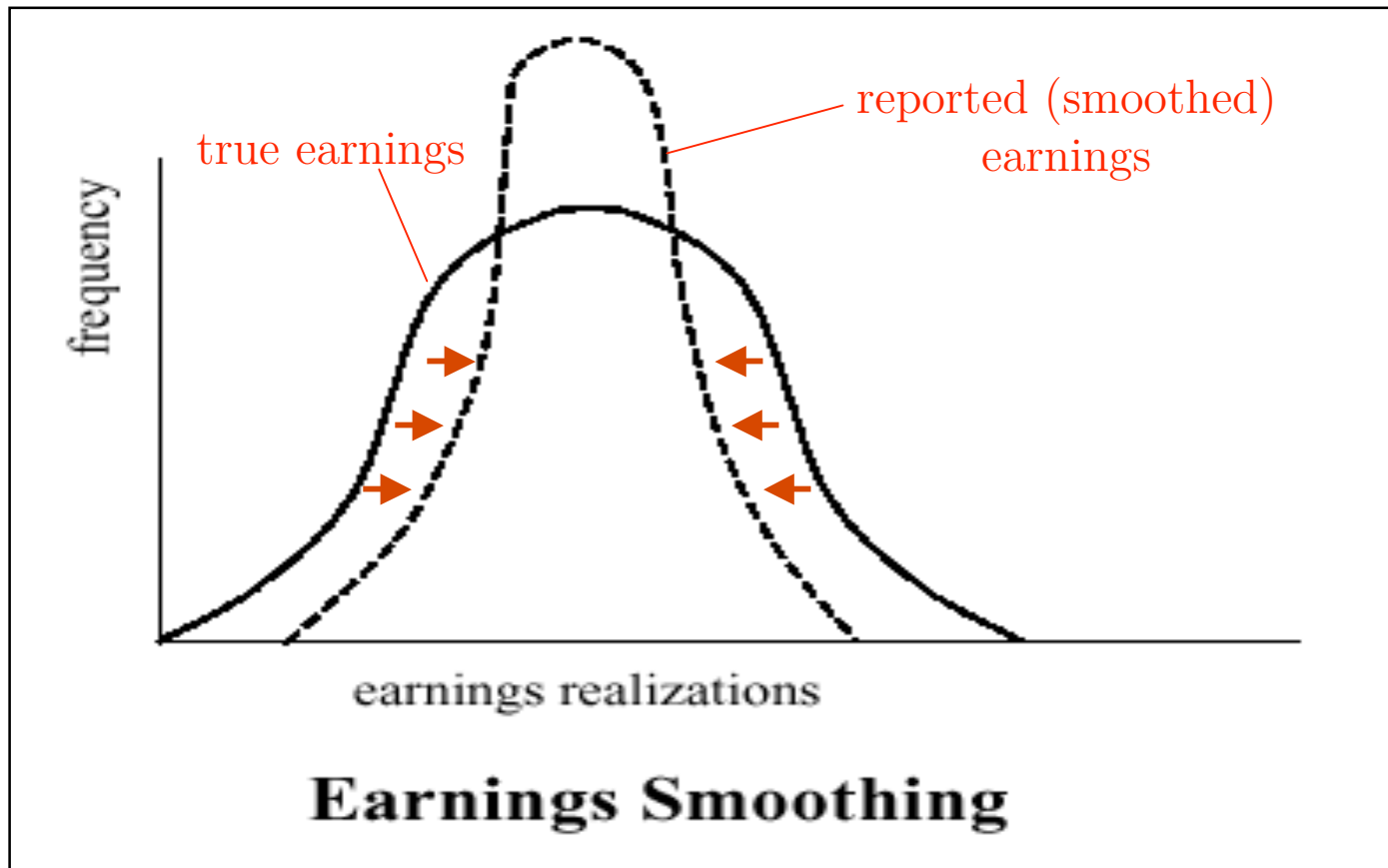
It's a tendency to delay the recognition of losses and speed the recognition of gains.

—Bhattacharya, Daouk and Welker (2003)



It's a tendency to manage earnings so as to avoid reporting losses in earnings when losses are small.

—Bhattacharya, Daouk and Welker (2003)



It's a tendency to use accruals to lower the volatility of reported earnings.

More CSR, Less EM.

Myopia avoidance hypothesis

A firm with good CSR will not behave myopically and thus does not undertake EM.

More CSR, More EM.

Predictable earnings hypothesis

Managers may choose to smooth earnings to lower earnings volatility and, in so doing, convey more valuable, more relevant information to uninformed investors.

(Fukui, 2000; Goel and Thakor, 2003)

More CSR, More EM.

Multiple objectives hypothesis

More CSR, more agency problems.

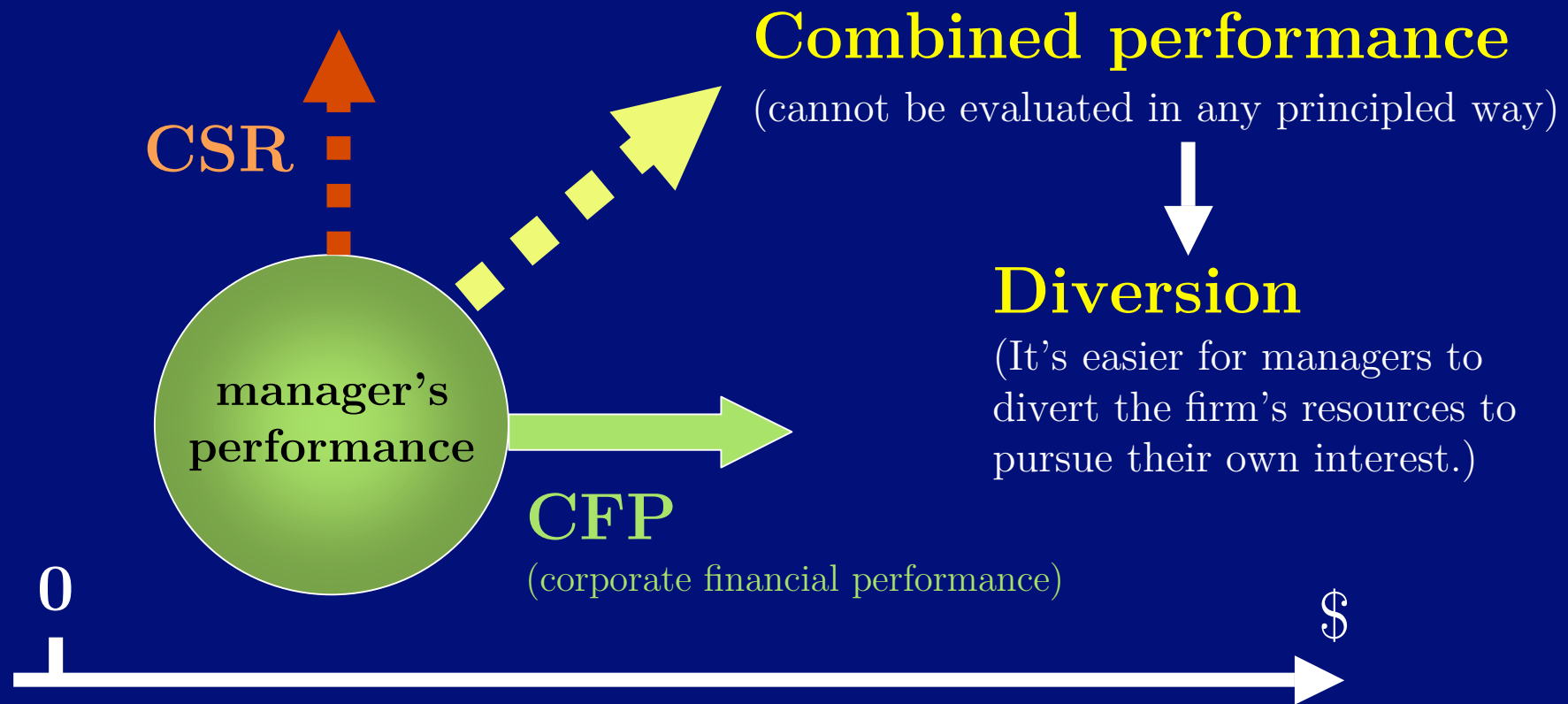
(Jensen, 2001)

More agency problems, More EM.

(Leuz, Nanda and Wysocki, 2003)

More CSR, More agency problem.

–Jensen (2001)



More agency problem, More EM.

– Leuz, Nanda and Wysocki, 2003

Diversion↑

(Managers divert more of the firm's resources to pursue their own interest.)



EM↑

Managers will undertake more EM to hide these diversion activities, to diminish the likelihood of outsider interference.

CSR is irrelevant with **EM**

Institutional hypothesis

It is ‘perverse’ incentives, not a decline in ethics, cause scandals. Such incentives include increased auditor acquiescence, growth in equity-based compensation, and the herding behavior of fund managers, none of which are related to business ethics.

(Coffee, 2003)

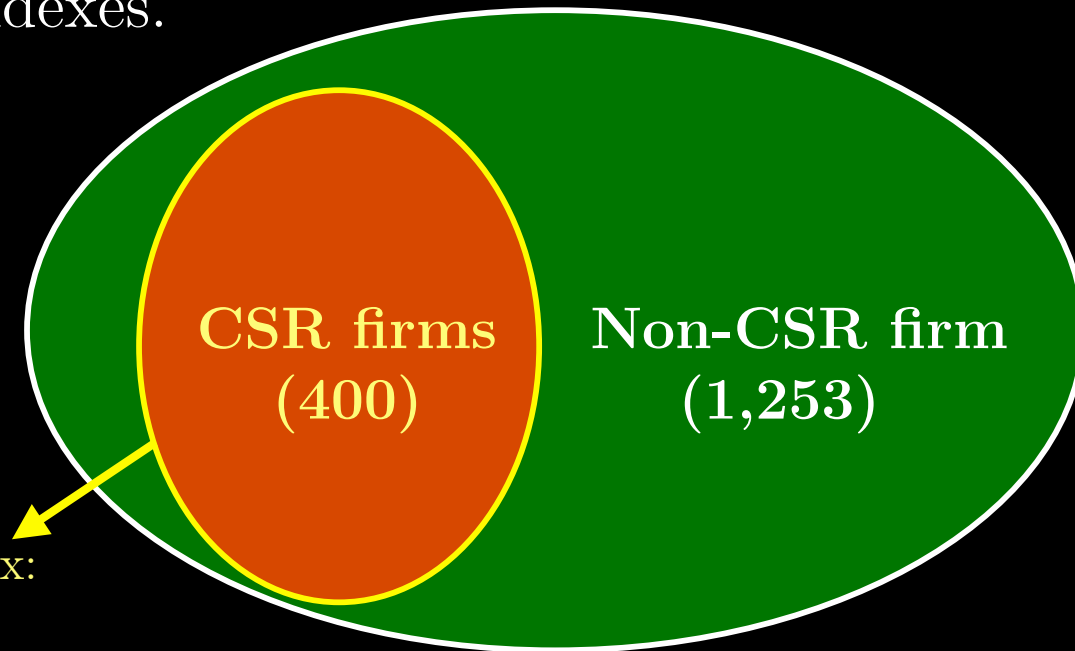
To the best of our knowledge,
empirical studies that have directly
examined whether CSR and EM
are related or not have been few.

Therefore...

The paper investigates whether the CSR-related features of 1,653 corporations in 46 countries had a positive or negative effect on the quality of their publicly-released financial information during the 1993-2002 period.

Data of CSR

- In order to measure CSR across firms and countries, our CSR companies are constituents in the FTSE4Good Indexes.
- **CSR :**



FTSE4Good Global Index:

- (1) Environmental
- (2) Social and Stakeholder
- (3) Human Rights

**FTSE All-World Developed
Index (Global) (1,653)**

The constituents in the FTSE4Good are classified as CSR companies, whereas the constituents in the FTSE All-World Developed Index but not in the FTSE4Good Index are referred to as Non-CSR companies.

We then screen the Compustat Global Vantage database for CSR and Non-CSR firms to fetch the required financial data from January 1993 to December 2002.

Some empirical results

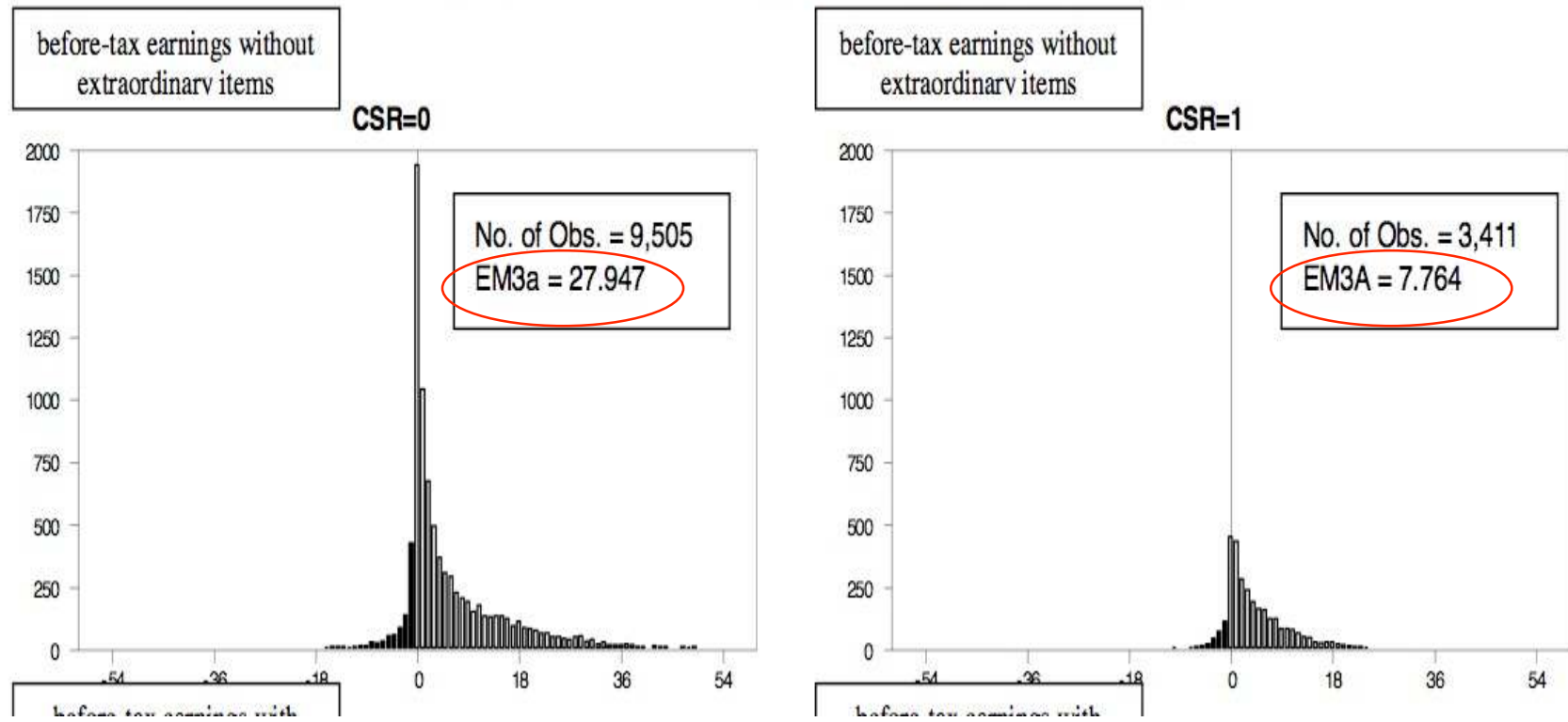
Table 5
Determinants of Earnings Smoothing (EM1)

	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)
Total Assets			-0.028** (-2.354)			-0.027** (-2.222)		-0.017 (-1.268)
Market-to-Book Ratio			-0.001 (-1.424)			-0.001 (-1.472)		-0.001 (-1.463)
Debt-to-Equity Ratio			0.0001 (1.014)			0.0001 (1.072)		0.0001 (1.069)
Auditor			-0.117*** (-3.096)			-0.098** (-2.543)		-0.076* (-1.940)
Antidirector Rights				-0.028* (-1.955)			-0.052*** (-2.935)	-0.057*** (-3.212)
Legal Enforcement				-0.035*** (-3.059)			-0.035*** (-2.916)	-0.025* (-1.890)
Per-capita GDP		-0.037*** (-2.325)						
CSR	-0.103*** (-2.960)	-0.077** (-2.099)	-0.034 (-0.919)	-0.051 (-1.351)	-3.988*** (-2.759)	-3.539** (-2.346)	-4.476*** (-3.090)	-3.973*** (-2.627)
Antidirector Rights × CSR					0.026 (1.002)	0.033 (1.231)	0.078* (2.464)	0.089*** (2.771)
Legal Enforcement × CSR					0.040 (0.530)	0.048 (0.619)	0.075 (0.976)	0.076 (0.966)
per-capita GDP × CSR					0.332** (2.434)	0.284** (2.018)	0.332** (2.434)	0.281** (1.991)

Table 6
Determinants of Earnings Aggressiveness (EM2)

	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)
Total Assets			-0.012 ^{***} (-4.995)			-0.014 ^{***} (-5.089)		-0.016 ^{***} (-4.930)
Market-to-Book Ratio			0.004 ^{***} (3.868)			0.004 ^{***} (3.843)		0.004 ^{***} (3.860)
Debt-to-Equity Ratio			-0.00003 ^{***} (-2.544)			-0.00003 ^{**} (-2.524)		-0.00003 ^{***} (-2.609)
Auditor			0.012 (1.523)			0.014 [*] (1.722)		0.012 (1.368)
Antidirector Rights				0.009 ^{***} (2.825)			0.002 (0.665)	-0.001 (-0.447)
Legal Enforcement				-0.002 (-1.129)			-0.00001 (-0.004)	0.008 ^{***} (3.180)
Per-capita GDP		-0.002 (-0.817)						
CSR	0.036 ^{**} (2.022)	0.036 ^{**} (2.010)	0.027 ^{**} (2.355)	0.034 [*] (1.880)	0.029 (0.086)	-0.343 [*] (-1.758)	0.036 (0.105)	-0.302 (-1.561)
Antidirector Rights × CSR					0.028 ^{***} (2.584)	0.014 ^{***} (2.894)	0.027 ^{**} (2.367)	0.015 ^{***} (2.868)
Legal Enforcement × CSR					-0.011 (-0.629)	-0.005 (-0.687)	-0.011 (-0.627)	-0.013 [*] (-1.764)
per-capita GDP × CSR					-0.001 (-0.037)	0.284 ^{**} (2.018)	-0.001 (-0.037)	0.037 ^{**} (1.983)

Figure 1. CSR and Avoiding Earnings Losses (EM3a)



Conclusion (1/3)

With a greater commitment to CSR,
earnings smoothing is less.

- myopia avoidance hypothesis (supported)
- multiple objectives hypothesis (rejected)
- predictable earnings hypothesis (rejected)

Conclusion (2/3)

With a greater commitment to CSR,
losses avoidance is less.

- myopia avoidance hypothesis (supported)
- multiple objectives hypothesis (rejected)

Conclusion (3/3)

With a greater commitment to CSR,
earnings aggressiveness is more.

- myopia avoidance hypothesis (rejected)
- multiple objectives hypothesis (accepted)

Thank you for your attention.

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