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Corporate social responsibility and earnings management in U.S. banks

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ABSTRACT

Business decision making depends on financial reporting quality. In identifying the drivers of financial reporting quality, proxied by earnings management (EM), prior literature has drawn attention to the association between corporate EM practices and commitment to corporate social responsibility (CSR). Empirical evidence, however, provides inconclusive results regarding the direction of this association. Using simultaneous equations, we examine the bi-directional CSR–EM relationship in U.S. commercial banks. We demonstrate that, although banks that engage in EM practices are also actively involved in CSR, the reverse relationship is not significant. We provide implications for investors, analysts, business participants and regulators.

1. Introduction

A few years ago, Lehman Brothers and Bear, Stearns & Co. Inc. were characterized as the most “prestigious”, “respected” and “durable” banks on Wall Street (Norton, 2011, p. 440, 448). They were also considered to be among America’s most admired investment banks since they occupied the top two positions within this industry sector in Fortune magazine’s 2007 Most Admired survey (Fortune, 2007).[4] A few months later, both banks were on the verge of collapse having been accused of poor-quality financial reporting which misled users of their financial information regarding their financial health (Jones, 2011a). These two episodes raise serious research questions about whether CSR and the quality of financial reporting are somehow associated and whether this association facilitates the decision-making processes of business organizations.

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[4] A number of studies have, however, underscored that the Fortune magazine’s Most Admired survey and other CSR ranking lists, such as the Newsweek environmental reputation list, may suffer from a financial halo effect which posits that broader CSR perceptions are possibly influenced by corporate financial performance (Brown and Perry, 1994; Fryxell and Wang, 1994; Guidry and Patten, 2010; Rozenzweig, 2009).

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While previous studies have substantiated that CSR is associated with the quality of financial reporting, as proxied by the intensity of earnings management (EM) practices[5] (see e.g. Chih, Shen, & Kang, 2008; Prior, Surroca, & Tribo, 2008), empirical findings remain inconclusive with regard to whether commitment to CSR has a positive or negative impact on the quality of financial reporting (see e.g. Chih et al., 2008) and vice versa. Given the diversity of findings and the importance of this relationship for academics and market participants, more research is needed (Kim, Park, & Wier, 2012).

In this vein, we explore the bi-directional CSR–EM relationship by focusing on the U.S. commercial banking industry. Banks constitute pivotal and indispensable institutions for the operation of businesses and the broader economy as a whole (Scholtens, 2006, 2009). The intermediating, financing and pricing activities of banks play a fundamental role in the allocation of capital and in what is broadly perceived as development and prosperity (Levine, 2004). Most banks appear to be committed to CSR activities, are included in the Dow Jones Sustainability Index (DJSI)[6] and participate in groups that have established strict principles to ensure their involvement in socially responsible investment activities (such as the Equator Principles group[7]). Interestingly though, a considerable number of them have been sanctioned for being involved in socially irresponsible practices (Heal, 2008). Some high-profile banks have been publicly denounced for gender discrimination, insider trading, fake bids, rigged auctions, money laundering, illegal use of confidential information, conflicts of interest and for financing companies involved in "sinful" activities (Heal, 2008). Moreover, in the financial reporting realm, banks have been more prone to EM practices than non-financial organizations (Greenawalt & Sinkey, 1988). Their diversified financial operations and products, such as derivative financial instruments (Heilpern, Haslam, & Andersson, 2009; Lewis, 2009), are characterized by great opacity and information asymmetry (Furfine, 2001; Levine, 2004; Mulbert, 2009), which essentially complicates their financial reporting processes (Hatherly & Kretzschmar, 2011) and makes EM practices less discernible to vigilant stakeholders and analysts (Morgan, 2002).

Against this background, we employ a sample of 116 listed commercial banks in the U.S. during a five-year period (2003–2007) to examine whether commitment to CSR activities has any relationship to the quality of financial reporting. We estimate a simultaneous equations system by employing a two-stage least squares (2SLS) regression method to control for any endogeneity problems. We measure a bank's CSR commitment by externally determined ratings provided by the Kinder, Lydenberg, Domini (KLD) database which has been extensively used in CSR research (see e.g. Ghoul, Guedhami, Kwok, & Mishra, 2011). By using KLD ratings we avoid any possible self-imposed bias in defining and measuring a bank's CSR commitment. Following prior research, we measure EM by using both loan loss provisions (LLPs) and realized securities gains and losses (RSGLs) as a proxy for capturing bank managers' discretionary decisions to manipulate earnings. We choose these measures over the alternative, the accruals choices approach, since it is apparently more difficult to determine discretionary choices if the latter is used (Beatty, Keand, & Petroni, 2002).

Our findings suggest that banks engaged in EM practices also tend to be deeply involved in CSR activities. Moreover, we show that the reverse relationship is not significant, i.e. that the degree of a bank's commitment to CSR is not associated with the quality of financial reporting. We demonstrate that, in the case of the U.S. banking sector, a one-directional association emerges, as we find that EM is a significant determinant of CSR. In light of these findings, we contribute to the extant literature by providing insights into the workings of an indispensable component of the operation of the U.S. economy – the commercial banking sector – which is characterized by a distinctive tendency to engage in EM practices and by a high level of participation in CSR. By deciphering the intertwining nature of EM and CSR in the case of the banking industry, we fill an important gap in the literature and contribute to the framework for decoding aspects of complex decision-making processes.

Our work is also distinct in that, while previous studies use cross-industry and cross-country datasets (e.g. Chih et al., 2008 studied 46 countries, and Prior et al., 2008 studied 26 countries), our study focuses on the (highly influential at an international level) U.S. banking sector. In this way, we aim to reduce the interference of any potential "noise" due to diverse environments and the operationalization of both CSR and EM proxies. Additionally, whilst previous studies have examined either the impact of EM on CSR (Prior et al., 2008) or the impact of CSR on EM (Chih et al., 2008), we provide a more comprehensive understanding of the CSR–EM relationship by bringing to the fore the element of reverse causality.

Our findings have important implications for shareholders, investors and analysts who may consider CSR as an expression of "ethical" investing and a possible reflection of the quality of financial reporting. These groups should be very cautious in relying on CSR information for a banking industry analysis, since CSR is found to be driven by EM and, at the same time, banks' CSR engagement is found to have no significant impact on EM. Additionally, through EM practices, managers may succeed in achieving both optimal levels of profitability and a high CSR record. In this manner, they may improve their personal reputation capital which enables them to claim increased benefits and rewards, better contracts, and board interlocks – often to the detriment of their organization's interests. Lastly, regulators should take into account the positive impact of

[5] Healy and Wahlen (1999, p. 368) define earnings management (EM) as occurring "when managers use judgment in financial reporting and in structuring transactions to alter financial reports either to mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers."

[6] Membership of the DJSI is acclaimed as an indication of leadership in terms of corporate sustainability. The DJSI uses the "best-in-class" approach by selecting the top 30 percent of companies in a specific industry based on sustainability criteria.

[7] Launched in 2003, the Equator Principles constitute a credit risk management framework for determining, assessing and managing environmental and social risk in project finance transactions (http://www.equator-principles.com/index.php/about; accessed on November 16, 2012).