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Investigating the relationship between corporate social responsibility and earnings management: Evidence from Spain

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Abstract This article investigates the relationship between corporate social responsibility and earnings management. Using panel data methodology for a sample of Spanish non-financial companies between 2005 and 2012, we find a negative impact of corporate social responsibility practices on earnings management. Corporate social responsibility is related to ethical and moral issues concerning corporate decision-making. Engaging in socially responsible activities not only improves stakeholder satisfaction, but also has a positive effect on corporate reputation.

The results show that corporate social responsibility practices may be an organizational device that leads to more effective use of resources, which then has a negative impact on earnings management practices.

Introduction

Earnings management has recently received considerable attention both from regulators and the popular press. Earnings management can be defined as the alteration of firms' reported economics performance by insiders to either mislead some stakeholders or to influence contractual outcomes (Healy and Wahlen, 1999; Leuz et al., 2003). Managers may be inclined to manage earnings due to the existence of explicit and implicit contracts, the firm's relation with capital markets, the need for external financing, the political and regulatory environment or several other specific circumstances (Vander Bauwhede, 2001). These deliberate managerial actions, contrived to disguise the real value of a firm's assets, transactions, or financial position, have negative consequences for shareholders, employees, the communities in which firms work, society at large, and managers' reputations, job security and careers (Zahra et al., 2005).

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Accounting earnings are more reliable and more informative when managers' opportunistic behavior is controlled through a variety of monitoring systems (Dechow et al., 1996). After several recent financial scandals, there has been an international trend toward developing and implementing corporate governance mechanisms to fight against the opportunistic behaviors that have undermined investors' credibility in financial information. Corporate governance attributes help investors by aligning the interests of managers with the interests of shareholders and by enhancing the reliability of financial information and the integrity of the financial reporting process (Watts and Zimmerman, 1986).

Decades of empirical research have focused on the factors influencing the quality of earnings, specifically the accruals. However, there is also increasing attention being paid to the managerial activities which can lead to the manipulation of earnings. Previous studies document mixed results regarding the association between corporate social responsibility (CSR) and transparent financial reporting. In this article, we examine the relationship between CSR and earnings quality by using Spanish firms from 2005 to 2012. The earnings quality is measured by using the absolute value of abnormal discretionary accruals from the modified Jones model.

CSR is related to ethical and moral aspects about corporate decision-making and behavior and, as such, addresses complex issues like environmental protection, human resources management, health and safety at work, local community relations, and relationships with suppliers and customers (Castelo and Lima, 2006). Engaging in socially responsible activities not only improves stakeholder satisfaction, but also has a positive effect on corporate reputation (Orlitzky et al., 2003) and reduces the financial risk incurred by the firm (Orlitzky and Benjamin, 2001).

CSR research has employed a variety of theories and methodologies to study the potential relationship between CSR activities and other traditional measures of a firm's success (Mahoney and Roberts, 2007, p. 234). Previous studies focus on the link between CSR and economic or financial firm's performance (Moore, 2001; Orlitzky et al., 2003; Brammer et al., 2007) and the evidence is mixed. As Jorgensen and Knudsen (2006) note, this relationship represents the most questioned area of CSR (Angelidis et al., 2008); while a lot of research points in favor of a mild positive relationship (Aupperle et al., 1985; McGuire et al., 1988; Orlitzky et al., 2003; Maron, 2006; Wu, 2006; Rodgers et al., 2013) this connection has not been fully established (Neville et al., 2005; Prado-Lorenzo et al., 2008; Park and Lee, 2009) and the mechanisms through which financial performance is enhanced by CSR is not well understood (Jawahar and McLaughlin, 2001; Doh et al., 2009). The literature review suggests there remains a lack of understanding about how CSR initiatives can influence on accounting quality by reducing earnings management. Accordingly, our study fills this gap by studying the effects of CSR practices on discretionary accruals.

The country's legal system, economic development, the importance of stock markets and ownership concentration all affect the country's accounting standards, which in turn affect the country's quality of financial reporting. We use Spanish data because they generally reflect an institutional setting similar to most continental countries, classified by La Porta et al. (1997) as French-origin civil law countries, where high concentration of ownership, weak investor rights and boards which are not independent of controlling shareholders are prevalent.[1] Fundamental stakeholders in the Spanish corporations include banks and industrial firms, although the role of financial institutions is not as prevalent as in other countries such as Germany and Japan, and the main agency problem arises from controlling and minority shareholders, as occurs in most European countries. The international accounting literature provides evidence that the magnitude of earnings management is on average higher in code-law countries with low investor protection rights, compared to common-law countries with high investor protection rights (Ali and Hwang, 2000; Ball et al., 2000; Leuz et al., 2003).

The publication of new European rules or codes of best practice for publicly listed companies has further intensified the discussion in Spain. However, Spain is a country in which corporate social responsibility ranks significantly behind others such as the USA and the UK. The reason must be sought in a culture which, to date, has not given sufficient importance to responsible corporate behavior. The Spanish Accounting Standards Board obliges Spanish firms to produce and disclose an environmental report in their annual accounts owing to the financial repercussions this information has on firms and the growing demand for this information from users. But social information is considered voluntary information.

The study is organized as follows. We review earlier research and provide the rationales for our hypothesis in 'Literature review and hypothesis development' section. This is followed by a presentation of the methodology, including how the sample was obtained and the data gathered and how the variables used were measured in 'Research design' section. We describe the analysis of the results in 'Results' section and the study ends with the main conclusions in 'Conclusion' section.

Literature review and hypothesis development

The impact of CSR on economic performance has received considerable attention in the literature over the past three decades (Waddock and Graves, 1997; Griffin and Mahon, 1997; McGuire et al., 1988; McWilliams and Siegel, 2000, 2001; Hillman and Keim, 2001; Simpson and Kohers, 2002; Orlitzky et al., 2003; Coombs and Gilley, 2005; Brine et al., 2006; Margolis et al., 2009; Aras et al., 2010). The instrumental stakeholder theory (Donaldson and Preston, 1995; Donaldson, 1999; Jones and Wicks, 1999) argues that good management implies positive relationships with key stakeholders, which, in turn, improve financial performance (Freeman, 1984; Waddock and Graves, 1997). The main idea here is that everything else being equal, firms that practice stakeholder management will perform better in profitability, stability and growth (Pesqueux and Damak-Ayadi, 2005).

[1] La Porta et al. (1999) report that 85 per cent of Spanish firms have a controlling shareholder, in contrast to only 10 per cent in the UK or 20 per cent in the US.