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# Corporate Social Responsibility and Earnings Quality: International Evidence

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## Abstract

In this paper, we investigate whether the corporate social responsibility (CSR) orientation of a firm affects its reporting incentives, in terms of the trade-off between real earnings management (REM) and accrual-based earnings management (AEM). Furthermore, relying on previous literature on the relationship between legal enforcement and the trade-off between AEM and REM, we consider whether the CSR orientation plays a moderating role in this relationship. We base our study on a sample of 5,863 firm-year observations for 1,141 unique firms, covering 24 different countries over the period 2003–2009. We find that CSR-oriented firms are less likely to engage in REM than in AEM. Moreover, we document that in strong legal enforcement countries, incentives to use REM instead of AEM are significantly lower in companies with a high CSR orientation than in companies with a low CSR orientation. These findings are consistent with the expectation that CSR-oriented companies are less likely to engage in the more costly but harder to detect earnings management strategy, i.e. the strategy that alters the underlying real operations of the company (REM). We provide additional evidence for our arguments that CSR-oriented firms are more likely to give up REM than AEM because of its detrimental value on future performance. All together our evidence suggests that CSR orientation acts as a constraint for REM and in doing so it contributes to the creation of value for all stakeholders.

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*Keywords:* Corporate social responsibility; Accrual earnings management; Real earnings management; Enforcement; Performance

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## 1. Introduction

This paper investigates whether corporate social responsibility (CSR) orientation plays a role in the choice between alternative earnings management (EM) strategies. Specifically, we focus on the trade-off between real earnings management (REM) and accrual earnings management (AEM) and we furthermore consider whether CSR orientation interacts with existing external factors (country legal enforcement) that shape the trade-off between AEM and REM. Our evidence, while supporting prior evidence that CSR-oriented firms are less likely to be involved in earnings management activities, also suggests that CSR-oriented firms are more likely to engage in AEM than in REM. Moreover, while previous literature shows that firms tend to substitute AEM with REM under a strict legal enforcement regime (Cohen, Dey, & Lys, 2008; Durnev, Li, & Magnan, 2011; Ipino & Parbonetti, 2011), we find that the CSR orientation of the firm contributes to explaining this substitution effect. In particular, the CSR orientation has a mitigation effect, as it counterbalances the reporting incentives stemming from the external legal environment.

Previous literature on the relationship between CSR and earnings management (Calegari, Chotigeat, & Harjoto, 2010; Hong & Andersen, 2011; Kim, Park, & Wier, 2012; Litt, Sharma, & Sharma, 2014; Scholtens & Kang, 2013) generally shows that CSR-oriented firms are less likely to manage earnings through discretionary accruals and manipulating real operations, thereby providing evidence that ethical concerns are likely to drive managers to produce high-quality financial reports. Furthermore, the accounting literature has also documented the existence of a trade-off among earnings management strategies, as firms use AEM and REM as substitutes (Cohen et al., 2008; Zang, 2012). Previous research has also shown that firms prefer REM to AEM when enforcement is high (Cohen et al., 2008; Durnev et al., 2011; Ewert & Wagenhofer, 2005). This is because REM is more difficult to detect than AEM. Nevertheless, the shift from AEM to REM presents legitimate concerns because, unlike AEM, REM modifies firms' operations, diverting them from their normal course without an underlying economic reason (Roychowdhury, 2006). According to the survey by Graham, Harvey, and Rajgopal (2005), executives who engage in REM are willing to burn real cash flows and forego projects with a positive net present value, making this earnings management strategy more costly than AEM.

We build on this literature to explore how CSR shapes reporting incentives when it comes to choosing between alternative EM strategies. Rather than just investigating the effect of CSR orientation on the level of earnings management in an international setting, we try to understand what forces are in place when a company has to choose among alternative earnings management strategies. First, we investigate if CSR orientation influences the trade-off between AEM and REM. We argue that because REM is more costly for the firm's future competitiveness (Cohen & Zarowin, 2010), CSR-oriented firms are less likely to use REM than AEM, as their responsibility towards stakeholders would imply greater commitment to the firm's future viability.

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