Journal of Accounting and Economics 60 (2015) 56–72

Contents lists available at ScienceDirect

Journal of Accounting and Economics

journal homepage: www.elsevier.com/locate/jae

Signaling through corporate accountability reporting

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ARTICLE INFO

Article history:
Received 16 January 2014
Received in revised form
26 February 2015
Accepted 6 March 2015
Available online 16 March 2015

JEL classification:
M41
D82
G14
G30
G32
G34

Keywords:
Corporate accountability reporting
Corporate social responsibility
Voluntary disclosure
Signaling

ABSTRACT

We document that corporate social responsibility ("CSR") expenditures are not a form of corporate charity nor do they improve future financial performance. Rather, firms undertake CSR expenditures in the current period when they anticipate stronger future financial performance. We show that the causality of the positive association between CSR expenditures and future firm performance differs from what is claimed in the vast majority of the literature and that corporate accountability reporting is another channel through which outsiders may infer insiders' private information about firms' future financial prospects.

1. Introduction

We examine the relation between corporate social responsibility ("CSR") expenditures and firm performance.[1] The motivation for our approach is based on two observations. First, there is a significant debate as to the merits of CSR activities (Margolis et al., 2007). While some researchers find support for what is commonly referred to as "doing well by doing good" (e.g., Servaes and Tamayo, 2013; Fombrun, 2005), others suggest that CSR activities are an irresponsible use of corporate resources (e.g., Friedman, 1970). Second, researchers have addressed this debate through studies that investigate whether there is a positive association between CSR initiatives and different aspects of economic performance. The underlying assumption in these studies is that evidence of a positive association implies that CSR expenditures lead to improvements in a firm's performance. We hypothesize that the causality does not necessarily go from CSR expenditures to financial performance. Rather, we posit that a firm may undertake a CSR initiative because the firm expects strong future financial performance.

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[1] Some specific examples of CSR initiatives can be found in the Corporate Social Responsibility in Practice Handbook, available online at http://www.pathfinder.org/publications-tools/pdfs/CATALYST-Corporate-Social-Responsibility-in-Practice-Casebook.pdf.

http://dx.doi.org/10.1016/j.jacceco.2015.03.001
0165-4101/

This latter point can be illustrated by a simple example. Assume that a firm has a breakthrough in its operations that will result in substantially increased profitability in the future. In addition, suppose that this firm started a new CSR initiative in the current year. Based on these facts, a researcher examining this firm might conclude that increased CSR expenditures led to improved financial performance by looking at the relation between current CSR expenditures and future financial performance. However, it could be that the firm began to invest in CSR in anticipation of its strong future performance. The omitted variable in this example, management's private information about the future prospects of the firm, impacts not only whether there is an association between CSR expenditures and future firm performance, but also the direction of the causality.

Based on this motivation, we examine three possible explanations for CSR expenditures. First, firms undertake CSR activities not because they increase firm value but because they are beneficial for society – we refer to this as the charity hypothesis.[2] Second, firms undertake CSR activities because they are investments that generate positive economic returns – we refer to this as the investment hypothesis.[3] Third, CSR expenditures are undertaken by firms who expect strong future performance, with the result that CSR expenditures "signal" information about firms' future prospects – we refer to this as the signaling hypothesis. The key distinction between the charity hypothesis and the investment and signaling hypotheses is that the former is not associated with improved financial performance. The key distinction between the signaling and investment hypotheses is that, in the case of signaling, the firm's financial performance is not the result of CSR expenditures; rather the firm's decision to undertake CSR activities is a result of managements' expectations of future financial performance.

We begin our analysis by first establishing whether a positive association exists between current CSR expenditures and future firm performance. Consistent with prior studies, we document a positive relation between CSR expenditures and future performance, as measured by changes in both return on assets and operating cash flow, but only an insignificant association when future performance is measured with size adjusted stock return. These results are inconsistent with the charity hypothesis, which implies that CSR expenditures should not impact the firm's future performance, but are consistent with both the investment and signaling hypotheses.

Next, we examine the direction of the causality between CSR expenditures and future performance to identify whether the relation is consistent with either the signaling or investment hypothesis. The methodological innovation of our analysis that allows us to examine the direction of the causality is the use of a two-stage approach, in which we first split CSR expenditures into two components: (a) the component that can be explained by economic-based factors (i.e., the "optimal" CSR expenditure) and (b) the component that is unrelated to economic-based factors (i.e., the deviation from the optimum).[4] We split CSR expenditures using a first stage regression that includes economic drivers of CSR expenditures documented in prior research; the fitted value from this regression is the optimal and the residual is the deviation.

We then examine whether different proxies for future financial performance are associated with these two components of CSR expenditures. This approach allows us to identify whether future performance is associated with either the optimal level of CSR expenditure or the deviation from that optimum, which in turn allows us to discriminate between the investment and signaling hypotheses. If CSR spending is a good economic investment, then there will be a positive association between optimal CSR expenditure and future firm performance. On the other hand, if CSR expenditures convey information about a firm's future prospects, then there will be a positive association between the deviation from the optimum and future firm performance.[5] We find that, on average, the improvement in firms' future performance is associated with the deviation rather than the optimal CSR expenditure. Based on these results, we conclude that the positive association between future performance and CSR expenditures is more likely due to the signaling value of CSR expenditures rather than positive economic returns on those expenditures.

Our identification strategy relies on the assumption that the residual from the first stage model is exogenous with respect to the financial performance variables in the second stage model. This assumption is reasonable to the extent that the first stage model is complete, an assumption that we believe is reasonable given the high explanatory power of the first-stage model. To provide additional assurance that our results are not partially attributable to an incomplete first stage model, we augment our first stage model by including lagged values for CSR expenditures. Under this approach, we are including all information available to the market, not just information that determines optimal CSR expenditures. The results from this approach provide further support for the signaling hypothesis. We also use a single-stage model in which each determinant of the optimal CSR expenditure has a direct and unconstrained relation with firm performance. As some of the variables in our first-stage model are associated with both financial performance and CSR expenditures,

[2] Finding empirical support for the charity hypothesis does not rely on a firm making charitable contributions. Rather, this hypothesis is supported when CSR expenditures, regardless of type, are not associated with future financial performance. Under this formulation, there are several possible explanations for a finding that supports the charity hypothesis. We discuss this point in detail in Section 2.

[3] For example, CSR expenditures might improve a firm's reputation, increase employee morale and productivity, mitigate political costs and enhance the firm's ability to negotiate with regulators, thereby resulting in better product market outcomes, such as allowing the firm to charge higher prices.

[4] This methodological approach is new to the CSR literature. However, it has been used in other areas of research, such as executive compensation (e.g., Bebchuk and Grinstein, 2005). The optimal and deviation terminology we employ is consistent with this literature.

[5] Of course, these effects are not mutually exclusive – it is possible for both the optimal CSR expenditure and deviation to have positive associations with future firm performance.