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# Do Economic Incentives of Controlling Shareholders Influence Corporate Social Responsibility Disclosure? A Natural Experiment<sup>☆</sup>

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## ABSTRACT

We evaluate whether voluntary corporate social responsibility (CSR) disclosure is influenced by the economic incentives of controlling shareholders. To examine this research question, we apply the natural experiment setting based on the Split Share Structure Reform in China. Following this Reform, Chinese state shareholders are allowed to trade their shares in the stock market, which increases their incentives to maximize the market value of the firms that they control. We present empirical evidence of increased CSR disclosure among listed state-owned enterprises after this Reform. This evidence suggests that the economic incentives of key stakeholders are associated with voluntary CSR disclosures.

## 1. Introduction

This study examines whether the economic incentives of controlling shareholders affect voluntary corporate social responsibility (CSR) disclosures. The existing literature on the impact of capital market incentives on CSR reporting provides evidence that such disclosures can be influenced by firms' intention to reduce the cost of equity capital (Dhaliwal, Li, Tsang, & Yang, 2011) and their reliance on external finance (Barth, McNichols, & Wilson, 1997). However, research designs based on cross-sectional analyses can be affected by endogeneity problems. There may be certain factors unobservable or unaccounted for that jointly determine both the level of CSR disclosure and the variables that capture capital market incentives, thus introducing a spurious correlation between the two. Alternatively, natural experiments associated with relatively more exogenous events such as government policy changes may contribute to the reduction of these endogeneity concerns (Meyer, 1995).

As such, in contrast to existing studies, we exploit a natural experiment setting based on the Split Share Structure Reform (SSSR) in China to investigate whether changes in economic incentives of corporate insiders affect the voluntary disclosure of CSR-related information. The SSSR, which took effect in 2005, abolished the trading restrictions of shares held mainly by the controlling shareholders of state-owned enterprises (SOEs). Prior to the Reform, such shareholders were largely indifferent to changes in their firms' market value since the restricted shares they held cannot be freely traded in the stock market (Firth, Fung, & Rui, 2006). Following the Reform, however, such shareholders tend to have stronger incentives to maximize their firms' market value because their previously restricted shares have now become tradable (Liao, Liu, & Wang, 2014).

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We formulate the following testable predictions regarding the effect of the Reform on the CSR disclosures of Chinese listed firms. First, before the Reform, the likelihood of CSR disclosures should be lower among SOEs than non-SOEs (NSOEs). This is because the lack of alignment between the wealth of controlling shareholders and the market value of their firms could reduce the incentives of the SOEs to communicate with outside investors. Second, after the Reform, the probability of disclosing CSR information is expected to increase more among listed SOEs than their NSOE counterparts. This is because the Reform exogenously generated economic incentives for the controlling shareholders of SOEs to maximize their firms' market value, and CSR reporting could contribute to this effort (Cahan, De Villiers, Jeter, Naiker, & Van Staden, 2016; Clarkson, Fang, Li, & Richardson, 2013; Clarkson, Li, Richardson, & Vasvari, 2011; Dhaliwal, Radhakrishnan, Tsang, & Yang, 2012; Dhaliwal et al., 2011; Griffin & Sun, 2013; Plumlee, Brown, Hayes, & Marshall, 2015). Finally, the increase in CSR disclosure after the Reform is likely to be greater when the controlling shareholders could obtain more economic gains from the abolishment of the restricted shares.

To test these assertions, we apply a sample derived from Chinese listed firms over the period of 2008 to 2013. We provide empirical evidence consistent with the three aforementioned predictions and robust to the controls of other determinants of CSR disclosure identified in the existing literature. Our study offers the following contributions. First, using a natural experiment setting based on the SSSR, we provide novel evidence to the literature on CSR reporting by confirming that the economic incentives of controlling shareholders play an influential role in driving such disclosures. Second, using the CSR disclosure context, we expand the literature on the impact of the SSSR in China (e.g., Chen, Chen, Schipper, Xu, & Xue, 2012; Liao et al., 2014; Liu & Tian, 2012), by documenting that this Reform motivates the voluntary disclosure of non-financial information.

The remainder of this paper is organized as follows. Section 2 reviews the literature. Section 3 explains the institutional background. Section 4 develops our testable hypotheses. Section 5 describes the research design. Section 6 presents the empirical findings. Section 7 presents the study's conclusions.

## 2. Literature review

The existing literature argues that the capital market concerns of firms should influence their CSR reporting because such disclosure may affect the information asymmetry and the litigation risks, as well as socially aware stakeholders (Barth et al., 1997; Dhaliwal, Li, Tsang, & Yang, 2014). However, empirical studies on the relation between firm value and CSR disclosure reveal mixed findings. On the one hand, certain studies document a positive association between voluntary environmental disclosure and firm value (Cahan et al., 2016; Clarkson et al., 2011; Clarkson et al., 2013; Griffin & Sun, 2013; Plumlee et al., 2015).<sup>1</sup> Such evidence is consistent with the findings that voluntary CSR disclosure contributes to the reduction of analyst forecast errors (Dhaliwal et al., 2012) and the reduction of the cost of equity capital (Dhaliwal et al., 2011). On the other hand, certain studies report a negative relation between CSR disclosure and firm value (Freedman & Patten, 2004; Lorraine, Collison, & Power, 2004; Richardson & Welker, 2001). To the extent that these studies primarily focus on negative CSR information or events, their evidence may be driven by the confounding effect of poor CSR performance (Aerts, Cormier, & Magnan, 2008; Qiu, Shaikat, & Tharyan, 2016). Overall, the mixed empirical evidence in this literature could be at least partly attributed to the research design limitations of cross-sectional analyses to address the potential endogeneity problems.

## 3. Institutional background

China offers a natural experiment setting to examine if capital market incentives can influence CSR disclosure on a relatively more exogenous basis. Before 2005, the Chinese stock market was characterized by a two-tier system known as the split share structure, which classified shares into tradable and restricted shares. The latter cannot be traded freely in the stock exchanges and are mainly held by state shareholders represented by central and local government asset management agencies or affiliated SOEs to help maintain government influence especially among listed SOEs. Without a direct link between firms' market value and the wealth of state shareholders, the controlling shareholders of listed SOEs lack incentives to promote the stock market performance of their firms in the interests of minority shareholders (Conyon & He, 2014; Firth, Fung, & Rui, 2007; Firth et al., 2006). On April 29th, 2005, the China Securities Regulatory Commission (CSRC) announced its decision to abolish the split share structure through a gradual firm-specific process.<sup>2</sup> The Reform offers state shareholders the opportunity to trade their previously restricted shares, but does not mandate them to sell their shareholdings. As such, the Reform creates economic incentives among state shareholders to help enhance the market value of their firms even if they do not immediately sell their shares.

A sizable body of literature studying the economic outcomes of the SSSR has provided evidence that it induced significant institutional changes to the Chinese SOEs, stimulated the state shareholders to improve their firms' stock market performance, reduced the agency conflicts between the controlling state shareholders and the minority private shareholders, and improved the corporate governance of these firms. For example, the SOEs' executive compensation has become more closely related to the stock returns since the Reform (Hou, Lee, Stathopoulos, & Tong, 2016), the foreign investors' discount of Chinese listed firms has been alleviated (Hou & Lee, 2014), and CEOs are held more accountable for corporate fraud with fraudulent management more likely to be

<sup>1</sup> Using a Chinese setting, Zhang, Wang, and Fung (2014) document a positive market reaction to media reports disclosing the CSR involvement for Chinese firms.

<sup>2</sup> For each firm, the Reform requires the restricted and tradable shareholders to negotiate and reach an agreement on the level of consideration to be offered by the former to the latter group (Zeng & McLaren, 2014). While the restricted shares offered as consideration become tradable at once, those remaining in the hands of restricted shareholders become gradually and increasingly tradable in the stock market within 36 months from the end of the negotiation process. By the end of 2011, restricted shares had been largely abolished across Chinese firms since most firms had completed their negotiation process by the end of 2008.

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