

The Halo Effect of Corporate Social Responsibility: Evidence from Accounting Restatements

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Motivation – Importance of Reliable Financial Reporting

*“Comprehensive, accurate and reliable financial reporting is the bedrock upon which our markets are based because **false financial information saps investor confidence** and erodes the integrity of the markets. For our capital markets to thrive, investors must be able to receive an unvarnished assessment of a company's financial condition. Financial reports must provide transparency for investors, and must not obscure the truth, even if that truth is inconvenient. **The last decade is full of painful reminders of how important reliable information is to investors, to markets and to regulators.**”*

Andrew Ceresney, Former Director of the SEC Division of Enforcement



Motivation

- Restatements impose costs on companies
 - Significant market value loss around an accounting restatement
 - Company management is likely interested in efforts to reduce the likelihood of disclosing a restatement as well as ways to reduce negative capital market effects if they do disclose a restatement



Motivation (Cont'd)

- Socially responsible firms
 - regularly expend resources on community, philanthropic, environmental and employee satisfaction programs;
 - voluntarily supplement their financial reporting with separate CSR reports.
- Will the market be more lenient toward socially responsible firms when they restate their financial statement?



Research Questions

- Are capital markets more lenient toward socially responsible firms when they restate their financial statements?
- Is there an association between CSR and the likelihood of restating financial statements?
- Do socially responsible firms pay more audit fees than less socially responsible firms?



Value of CSR – Two Views

- “Doing well by doing good.”
- “CSR is window dressing or covering up.”



Prior Research – CSR

- CSR activities associated with market value & firm profitability
 - Kitzmueller and Shimshack, 2012; Benabou and Tirole, 2010; Margolis, Elfeinbein and Walsh, 2009
- CSR adds value indirectly through a “Halo Effect”
 - Hong and Liskovich (2015) find socially responsible firms are fined less when facing bribery enforcements of the Foreign Corrupt Practice Acts (FCPA)
 - Lins, Servaes, and Tamayo (2017) find that socially responsible firms are rewarded during times of crisis.



Prior Research – Restatements

- Factors associated with companies disclosing restatements
 - Corporate governance attributes & audit fees (Abbott et al. 2004; Beasley 1996; Efendi et al. 2007; Sherma 2014; Blankley 2012)
- Consequences to reporting financial restatements
 - Significant negative market reaction (Palmrose et al. 2004; Scholz 2008; Plumlee and Yohn 2010; Myers et al. 2013)
 - Higher cost of capital (Hribar and Jenkins 2004; Amel and Yuan 2015)
 - Auditor resignation or management change (Huang and Scholz 2012, Huang 2013; Farber 2005; Srinivasan 2005)
 - Lawsuits (Palmrose and Scholz 2004)



Prior Research – Audit Fees

- Positive association between audit fees and good governance attributes (Carcello et al. 2002 and Abbott et al. 2003)
- Mixed results for association between earnings quality and audit/non-audit fees:
 - Audit fees
 - Negative association with earnings management (Frankel et al. 2002)
 - No association with earnings management Ashbaugh et al. (2003)
 - Non-audit fees
 - Positive association with earnings management [Frankel et al. (2002) and Kinney et al. (2004)]
 - No association with earnings management [Ashbaugh et al. (2003) and Chung and Kallapur (2003)]



Contribution

- New evidence that CSR indirectly adds value to a firm through a “halo effect” by examining the effect of firm CSR on capital market reaction to accounting restatement announcements.
- New evidence on CSR and financial reporting quality by examining the association between CSR and financial restatements.
- Examine the link between CSR and audit fees



Conceptual Model and Hypothesis 1

•CSR, as a risk management measure, can be employed to mitigate the resulting damage to negative events:

–H1: Market reaction to high CSR firms restatement announcements is less negative than for low CSR firms.

$$CAR_{-t}^i = \sum_{t=-1}^{+1} AR_{it}$$

- Abnormal returns: firm daily return less the equally-weighted market index return for day t. The CAR is the sum of abnormal returns over the trading window (t_1, t_2) where day 0 is the announcement date
- Market index includes stocks traded on the NYSE, AMEX, and NASDAQ exchanges.



Conceptual Model and Hypothesis 2

Restatement = f [CSR + governance + discretionary accruals + firm and audit characteristics]

–H2a: High CSR firms are less likely to have accounting restatements

–H2b: High CSR firms are less likely to have fraud-related accounting restatements



Conceptual Model and Hypothesis 3

- Firms may pay more for higher quality or more audit services to improve financial reporting quality or to protect corporate image.

Audit fees = f [CSR + governance + discretionary accruals + firm and audit characteristics]

–H3: Relative to low CSR firm, high CSR firms have greater audit fees.



Sample

- Merge MSCI (formerly KLD) database with Audit analytics, COMPUSTAT, and CRSP.
- 25,913 firm years from 2001-2013.
- Exclude financial firms (those with SIC codes 6000-6999)
- Sample includes 4,916 restatements from 2001-2013



Restated year	Total firms	Restatement firms	
	#	#	%
2001	879	196	22.3%
2002	846	184	21.7%
2003	2,186	566	25.9%
2004	2,293	578	25.2%
2005	2,238	459	20.5%
2006	2,227	424	19.0%
2007	2,225	299	13.4%
2008	2,239	291	13.0%
2009	2,270	355	15.6%
2010	2,298	431	18.8%
2011	2,200	425	19.3%
2012	2,137	428	20.0%
2013	1,875	280	14.9%
Total	25,913	4,916	19.0%



H1 Variable of Interest: CSR

- Seven CSR categories: environment, community, human rights, employee relations, diversity, product, and governance.
- Governance is a distinct factor from CSR (Kim, Park, Wier, 2012, Gao, Lisic, and Zhang, 2014)
- CSR strength (concern): total number of strengths (concerns).
- High CSR strength: a firm with at least four responsible CSR activities.
- CSR score: CSR strength minus CSR concern



Year	Firm year #	Level of Strengths 0	of CSR >=4	High CSR Strength Mean
2001	879	331	125	0.14
2002	846	322	131	0.15
2003	2,186	1,344	136	0.06
2004	2,293	1,317	141	0.06
2005	2,238	1,202	178	0.08
2006	2,227	1,178	184	0.08
2007	2,225	1,128	211	0.09
2008	2,239	1,089	226	0.10
2009	2,270	1,121	223	0.10
2010	2,298	1,434	305	0.13
2011	2,200	1,386	311	0.14
2012	2,137	1,301	311	0.15
2013	1,875	813	346	0.18
Total	25,913	13,966	2,828	0.11



	Mean			N	
	CSR	Non-CSR	p-value	CSR	Non-CSR
CSR SCORE	2.61	-1.23	0.00	6,713	19,200
CSR STRENGTH	3.65	0.46	0.00	6,713	19,200
CSR CONCERN	1.04	1.69	0.00	6,713	19,200
Governance STRENGTH	0.20	0.12	0.00	6,713	19,200
Governance CONCERN	0.46	0.36	0.00	6,713	19,200
RESTATEMENT	0.19	0.19	0.60	6,713	19,200
FRAUD	0.019	0.023	0.03	6,713	19,200
SIZE	7.94	6.79	0.00	6,603	18,574
AUDIT FEES (\$ m)	3.48	1.75	0.00	6,453	18,436
NON AUDIT FEES (\$ m)	1.38	0.61	0.00	6,453	18,436



H1: Announcement effect

	Mean			N
	High CSR strength	Low CSR strength	P-value	High CSR/Low CSR
(-1, +1)	-0.001	-0.013***	0.007	309/2682
(-20, +1)	0.009	-0.011***	0.012	309/2680



H1: Announcement effect (Table 4, Panel B)

	CAR	
	(-1, +1)	(-20, +1)
High CSR strength	0.010*	0.022**
	(0.072)	(0.031)
CSR concern	0.001	0.001
	(0.595)	(0.655)
Change in net income/Assets	0.375***	0.495***
	(0.000)	(0.001)
Revenue-Restatement	-0.014***	-0.022***
	(0.003)	(0.005)
Board approval	-0.014**	-0.021**
	(0.015)	(0.018)
Year and industry effects	Yes	Yes
Observations	2,836	2,834
Adjusted R-squared	0.181	0.157



H2: Restatement propensity (Table 5)

	(1)			(2)			(3)		
	Restatement			Lower	Reported	Income	Revenue restatement		
				Restatement					
CSR	0.012			0.009			-0.001		
	(0.351)			(0.605)			(0.960)		
CSR strength		-0.006			-0.012			-0.062*	
		(0.708)			(0.577)			(0.096)	
High CSR strength			0.033			-0.084			-0.181
			(0.760)			(0.574)			(0.384)
CSR concern		-0.041**	-0.041**		-0.041	-0.040		-0.089**	-0.090**
		(0.040)	(0.038)		(0.114)	(0.117)		(0.032)	(0.030)
Year and industry effect	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	22,039	22,039	22,039	22,039	22,039	22,039	22,039	22,039	22,039
Pseudo R-squared	0.0315	0.0318	0.0318	0.0474	0.0478	0.0478	0.0492	0.0516	0.0508



H2: Restatement propensity (Table 5)

	(4) Fraud restatement		
CSR	-0.073**		
	(0.043)		
CSR strength		-0.156**	
		(0.011)	
High CSR strength			-0.886***
			(0.008)
CSR concern		-0.007	-0.005
		(0.901)	(0.931)
Year and industry effect	Yes	Yes	Yes
Observations	22,039	22,039	22,039
Pseudo R-squared	0.0796	0.0820	0.0813



Methodologies

- We examine the impact of CSR on the propensity to restate financials using Logit regression
- To reduce the concern of endogeneity for the decision to be a high CSR firm, we use several approaches:
 - Regression methods
 - Biprobit model (propensity to restate)
 - Heckman's two-stage treatment effect model (Audit fees)
 - Two-stage least squares (2SLS) regressions (Audit fees)
 - Matching methods
 - Propensity score matching (PSM)



H2: Restatement propensity-biprobit (Table 6)

	(1) Restatement		(2) LOWER REPORTED INCOME	
	Second-stage	First-stage	Second-stage	First-stage
High CSR strength	-0.682***		-0.627***	
	(0.000)		(0.001)	
CSR Con	-0.017		-0.016	
	(0.116)		(0.233)	
Democratic party strength		0.001**		0.001**
		(0.036)		(0.042)
Constant	-2.553***	-9.386***	-2.909***	-9.541***
	(0.000)	(0.000)	(0.000)	(0.000)
Year and industry effect	Yes	Yes	Yes	Yes
Observations	21,507	21,507	21,507	21,507
Endogeneity p-value	0.000		0.000	



H2: Restatement propensity-biprobit (Table 6)

	(3)	Revenue-	(4)	FRAUD-
	RESTATEMENT		RESTATEMENT	
	Second-	First-stage	Second-	First-stage
	stage		stage	
High CSR strength	-0.333**		-0.877***	
	(0.047)		(0.006)	
CSR Con	-0.035***		0.003	
	(0.008)		(0.842)	
Democratic party strength		0.001***		0.001***
		(0.000)		(0.000)
Constant	-3.457***	-9.566***	-3.365***	-9.571***
	(0.000)	(0.000)	(0.000)	(0.000)
Year and industry effect	Yes	Yes	Yes	Yes
Observations	21,507	21,507	21,507	21,507
Endogeneity p-value	0.000		0.000	



H2: Restatement propensity-Propensity score matching (Table 7)

Average treatment effect for the Treated of High-CSR firms

	Average treatment effect	p-value
Probability of restatement	0.052	0.090
Probability of restatement with lower earnings	0.014	0.576
Probability of revenue restatement	0.012	0.409
Probability of fraud restatement	-0.148	0.000



H3: Audit fees

	Dependent variable: Log(Audit Fees)				
	OLS	OLS	OLS	Treatment effect model	2SLS
CSR	0.005 (0.206)				
CSR strength		0.049*** (0.000)			
High CSR strength			0.220*** (0.000)	0.678*** (0.000)	3.920*** (0.000)
CSR concern		0.065*** (0.000)	0.065*** (0.000)	0.062*** (0.000)	0.023** (0.034)
Inverse Mills ratio				-0.270*** (0.000)	
Constant	8.739*** (0.000)	9.032*** (0.000)	8.916*** (0.000)	9.214*** (0.000)	11.694*** (0.000)
Year and industry effect	Yes	Yes	Yes	Yes	Yes
Observations	22,039	22,039	22,039	21,507	21,507
Adjusted R-squared	0.663	0.676	0.673		
Endogeneity test p-value					0.000



Conclusion and Implications

- High CSR firms receive a “halo effect” from the stock market.
- High CSR firms are significantly less likely to restate their financial statements due to fraud.
 - No difference in the propensity of overall accounting restatement.
- CSR firms spend more on auditing fees.



Future Directions & Limitations

- Further research could examine:
 - Other factors associated with or mitigating financial restatements
 - Additional CSR halo effects as related to capital markets
- Limitations of this study include the inherent noise in 8-K and 10-K financial statement disclosures and the uncertainty in firm motivation regarding CSR activities



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