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The Impact of Corporate Social Responsibility on Earnings Quality and Share Price

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Abstract:

The purpose of this study is to investigate the impact of Corporate Social Responsibility (CSR) on earnings quality and share price. There is a scarcity of studies examining these relations in Egypt. Furthermore, prior studies have shown mixed results about this relation. The study is carried out an empirical analysis based on data from 2010-2016 using linear regression models between CSR, four proxies of earnings quality (Discretionary Accruals, Earnings Persistence, Earnings Predictability and Income Smoothing) and share price. The results shows that corporations with higher commitment to CSR have high level of earnings quality and they are less likely to manage earnings, furthermore, CSR has no impact on share price in Egypt. Similar results are obtained when the ESG index approach is employed as an alternative measure for CSR and corporate governance as a control variable.

Key Words:

Corporate Social Responsibility- Earnings management
Earnings Persistence- Earnings Predictability - Earnings
Smoothing - Share price

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CHAPTER ONE

Introduction

Chapter One

Introduction

Corporate Social Responsibility (CSR) has received increasing attention in the past decades, among practitioners and in the academic literature. Also, reporting of socially responsible activities is becoming more relevant to investors, creditors and others who demand greater transparency about all aspects of business (Michaels, and Grüning, 2018). Many companies adopted moral values in their daily operations and developed ethical codes describing responsible behavior. They become increasingly aware of the importance of their role in solving social and economic problems.

This social responsibility contains the role that corporations play in promoting health and safety of their employees, protecting the environment, the fight against corruption and respect for human rights in the communities where they operate. By these activities, corporations aim to increase sales of their product portfolio (Elliott, et al., 2014).

Corporations are really out of good faith trying to serve society by offering different types of assistance and increasing public concerns for the environment, human rights, ethical aspects of business and other social issues that motivate corporation to increase their efforts to deal with their responsibilities to society (Olfa and Fauozi, 2014).

CSR reporting has proved to be a sufficient method in communicating and attracting investment and export opportunities. According to a study conducted by the Governance and Accountability Institute, in 2011, 53% of Standard & Poor's 500 companies around the world issued their Corporate Social Responsibility or Sustainability Reports, as compared to 19% in 2010. The amount of CSR reports published among: the Fortune 500 companies also increased significantly, from 100 companies with CSR reports in 2010 to 285 in 2011. This can be considered as a remarkable figure, reflecting the size and level of development of CSR reporting in global economy (Tran,2014).

The importance of CSR reporting increased especially, after the 2008 financial crisis which was the largest shock to the financial system not only in the U.S. but in the world (Cornett et al. , 2011). Most of the

shares prices sharply dropped and the volatility in financial markets were at a peak .The panic in the financial market and the shrink of trading activities were partially driven by the lack of information that limited the assessment of assets risks.

This financial crisis, encouraged corporations to consider a long-term view of their investors' business interests and to acknowledge and respond to their societal responsibilities .Furthermore, long term potential investors consider corporate social and environmental behavior as material to investment decisions due to the competitive advantage .CSR might give to corporation as well as protecting shareholders 'value, especially when the corporation faces negative events (Lauesen, 2013).

It is contended that a corporation which behaves socially and cares about its stakeholders will report transparent financial information and present a good picture of the overall financial position of the company generally and share price specially. The link between CSR disclosure and share price was investigated by different scholars with mixed results. This study fills a literature gap by addressing and providing evidence on whether CSR disclosure has an impact on shares price in Egypt as well as on earnings quality. A considerable number of Egyptian companies disclose their environmental and social activities. In addition to that, the Egyptian Exchange launched its S & P ESG index in March 2010(S & P Jones Indices , 2016).

The first and only ESG index in the Middle East and North Africa Region prepared to track the performance of companies listed on EGX that demonstrate leadership in environmental, social and corporate governance (ESG) issues. This Index aims at raising the profile of those corporations that performing well in the areas of environmental, social, and corporate governance responsibility when compared to their peers.

On the other hand, in the financial markets, earnings are considered as the most significant accounting item presented in financial reports. It also serves as a guideline for investment and the decision making, a core measure of a corporate's performance, and investors consider reported earnings to be a useful tool in estimating future returns and share prices.

Good earnings quality builds confidence in the minds of existing and potential investors as well as other stakeholders. Corporations which have

low earnings quality suffer from high cost of capital (Demerjian, et al., 2012). CSR disclosure provide non- financial information which are not readily available to market participants from other sources which improve transparency, then increases earnings quality and allows market participants to assess possible strategic advantages in evaluating the corporations and their shares. Therefore, the relation between CSR disclosures, earnings quality and share price is considered as an important issue.

1-1 Research Problem:

CSR creates favorable goodwill and makes business environments conducive and friendly, which will enable corporations to achieve their main objective of profit and shareholders' wealth maximization. Accordingly, numerous scholars attempted to clarify its concept, implementation, measurement and relation with financial performance of corporations (e.g. Carroll, 1999, Van Marrewijk, 2003, O'riordan, and Fairbrass, 2008). CSR constitutes actions where companies integrate social concerns into their business policies and operations; these social concerns include: environmental, economic, human rights, product quality and anti-corruption.

CSR theories are classified into four groups: (1) ethical theories, (2) political theories, (3) integrative theories, and (4) instrumental theories (Garriga and Melé, 2004). Ethical theories suggest that a corporation must accept social responsibility as an ethical obligation and give attention to the legitimate interests of all stakeholders. Political theories concern a corporation's relationship with society and suggest that a corporation needs to take into consideration the community where it is operating, finding ways of formalizing the corporation's willingness to improve the society. Integrative theory argues that corporation needs to integrate social demands into their plans because its success is depended on society, On the other hand, instrumental theories argue that any proposed social activity is accepted if only it is consistent with wealth creation.

Ethical, political, and integrative theories of CSR suggest that managers have an incentive to be honest, ethical in their business, and present a high standard of behavior. Hence, if managers engage in CSR according to these theories, they are more likely to constrain earnings management (EM) and provide high earnings quality (Kansel, and Batra, 2014, Kim, Bark and Wire, 2012)

On the other hand, some studies relying on opportunistic use of CSR suggest that managers might engage in CSR practices for personal interests rather than for the interest of the corporation and its stakeholders (McWilliams et al. 2006, Prior et al. 2008, Muttakin, Khan and Azim, 2015) Thus, corporations may engage in CSR as a kind of reputation insurance. This indicates that decisions to engage in CSR activities may be made to give stakeholders the impression that the corporation is good, when, in fact, the corporation is engaging in EM. In other words, it is possible that corporations with more CSR disclosures will report poor-earnings quality. Earnings quality refers to the accounting earnings that reflect information about the value of a company. It represents the degree to which reported earnings of an entity truly reflects the actual income.

Earnings quality proxies are divided into eight properties that have been widely used in accounting research. The properties are further divided into accounting-based and market-based earnings properties. The accounting-based earnings properties are accruals quality, income smoothing, persistence and predictability of earnings while the market-based properties are earnings variability, value relevance, timeliness of earnings and earnings conservatism (Dechow and Schrand, 2010). There is no agreed upon proxy used in all studies, so as shown, it is difficult to draw a conclusion about the nature of the relation between CSR and earnings quality. Nevertheless, Corporations have an implied social contract with stakeholders to conduct business on the basis of trust and ethics. Corporations implementing CSR attempt to meet the expectations of stakeholders and implement the social contract because in efficient markets all available information, financial and non-financial, is reflected in equity value, reducing the degree of information asymmetry and improving the disclosure practice is reflected on corporations' cost of capital and increasing share prices (Jizi, et al., 2016).

In view that the business market today seems to be globalized, that it may create a challenge for publicly-owned corporations to make its shares more attractive in the market for the investors all around the world (Welford, 2005). It is argued that one of the main goals for a corporation is to increase its profit and to expand their business. For this reason, they need to be more better and differentiate themselves from their competitors. They have to differentiate themselves in the market and work hard to create good relationships with its investors as well as its customers (Armstrong, Kotler and Parment, 2013). One thing that

probably is important for a corporation to become successful is that it should be able to think like an investor or as a customer or other stakeholders. A corporation engaging in CSR can use this as a tool for increasing its share price. It is therefore important for the corporation to understand and to know whether the investors actually do care about a corporation's engagement in CSR or not.

The relationship between CSR and share price has been documented in the literature, but studies on CSR and share prices have yielded mixed results with evidence of CSR being associated with a lower share price (Hassel et al., 2005), as well as evidence of CSR disclosure being associated with a higher share price (Schadewitz and Niskala, 2010; De Klerk and De Villiers, 2015).

These mixed arguments about the impact of CSR on earnings quality and share price lead to the problem of the research which is represented in:

- Are those possible corporations that do not invest in CSR policies are negatively influencing their share prices?
- Is earnings quality associated with CSR?

1-2 Objective of the Research:

The objective of this study is to examine the impact of CSR on earnings quality and share price.

1-3 Contribution of the Research:

- 1- limited researches have addressed the relationship between CSR, earnings quality and share price and to the best of the researcher's knowledge, no study has been conducted in Egypt involving these three variables, therefore this study has important implications to the investing community. If CSR affects earnings quality and share price, the findings can be useful to investors in differentiating accurate and transparent financial information from less reliable information.
- 2- Evidence from this study can help standard setters and regulators to understand corporations' business practices and reporting behaviors in light of CSR.
- 3- Prior research usually uses one proxy of earnings quality to investigate the link between CSR and earnings quality, and to the best of my knowledge, no study has used multiple proxies for earnings quality in Egypt. The present study uses alternative measurements (proposed proxy and ESG index) to estimate CSR with the aim of providing a

better and deeper understanding of the nature of the relationship among CSR, earnings quality and share price. In addition, using multiple proxies approach enhances the validity and reliability of the study findings, That is followed by robustness test to improve the results of the research

- 4- The study highlights issues such as CSR can drive managers to produce high quality financial reports and encourage investors to invest in socially responsible corporations.
- 5- By providing strong and consistent evidence on the relation between CSR, earnings quality and share price of a corporation, this sheds light on how CSR extends to other aspects of corporate system

The research found the following results: multivariate variables analysis (MANOVA) indicate that CSR has a significant impact on earnings quality variables grouped together as a one set of variables .In respect to the accruals quality, the findings reveal that discretionary accruals is negatively and significantly correlated with CSR, suggesting that corporations with higher levels of CSR show lower magnitudes of discretionary accruals.

Regarding the impact of CSR on earnings persistence as a proxy of earnings quality, the results reveal that, corporate social responsibility is significantly affecting, and positively related to earnings persistence, The results also show that CSR has a positive association with earnings predictability and has a significant impact, however the result shows that CSR is negatively but insignificantly influencing the income smoothing of listed firms in Egypt suggesting that the CSR does not impact on income smoothing, furthermore, the results show that CSR has insignificant effect and low relation to shares price means that CSR has no impact on share price.

In addition, several sensitivity tests are performed to compare and confirm that the main results are consistent and robust. In general, the findings are in line with the long-term perspective, which assumes a negative relationship between CSR and earnings quality while no impact of CSR on share price.

Results would have several implications, for firms' executives in terms of evaluating their financial transparency, which may help corporations to enhance investors' perception of the quality of earnings. Financial analysts may use the results presented in the research to evaluate how CSR, as a tool for constrain EM practices, affects capital market decisions. If the market perceives that corporations with higher levels of CSR are associated with higher financial reporting quality, this will be important for making investment decisions. Furthermore, gaining

a better understanding of the impact of CSR on share price can help authorities and regulators, in Egypt, to develop their regulations and make further recommendations on CSR. The results of the study can also be used as an empirical support for stock market authorities to evaluate the current CSR requirements and their role in increasing share price.

1-4 Organization of the Dissertation:

The remaining of the dissertation is organized as follows:

Chapter Two: Corporate Social Responsibility:

In this chapter the CSR is discussed by focusing on the following issues:

- 2-1 The concept of CSR
- 2-2 Professional organizations issues related to CSR
- 2-3 Advantages of Implementing CSR
- 2-4 Measuring CSR
- 2-5 CSR Disclosure.
- 2-6 CSR Disclosure in Egypt
- 2-7 Summary

Chapter Three: The Relation between: CSR, Earnings Quality and share price:

In this chapter the relation between corporate social responsibility, earning quality and share price is discussed by focusing on the following areas:

- 3-1 The Concept of Earnings Quality.
- 3-2 Factors affecting Earnings Quality.
- 3-3 Measurement of Earnings Quality
- 3-4 Earnings Quality and Accrual-Based Models
- 3-5 The relation between CSR and Earnings Quality
- 3-6 CSR and share price
- 3-7 Summary

Chapter Four: literature Review and Hypotheses Development:

This chapter discusses the previous studies related to the relationship between CSR and Earning Quality and studies related to the relation between CSR and share price then outlines the development of the research hypotheses.

Chapter Five: Empirical Study:

This chapter presents the study design and findings. It includes the following: a description of the population, an identification of the criteria

used to select the corporations tested, a list of data sources, identification of the selected dependent, independent variables and control variables, an indication of the statistical package used, finally, summary of the empirical study results and the major findings that have been generated throughout the study. This is followed by the presentation of the results of the tested models which are interlinked with the research problem and the different hypothesis, finally, the robustness test.

Chapter Six: Summary, Conclusions, limitations and Suggestions for Future Research

The chapter presents the conclusions that have been drawn both from the results part as well as the analysis part, explaining the study's limitations then followed by suggestions for future researches