Corporate Social Responsibility and Reporting Incentives in China

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EXTENDED ABSTRACT

This research aims to investigate the interplay between ethical incentives and other corporate reporting incentives (e.g., financial reporting incentives) on related-party transactions. Due to an increasing need to fulfil various social commitments (e.g., for environmental conservation, industrial waste reduction or giving back to society), corporate managers are increasingly interested in demonstrating their social responsibility rather than merely improving financial performance. One way for a firm to communicate corporate commitments for social responsibility to its stakeholders and the general public is to publish reports on its corporate social responsibility (CSR) initiatives. We hypothesize and find that the ethical drive for reporting on CSR initiatives has an interactive or moderating role with other corporate reporting incentives, and that these various incentives affect a firm’s corporate strategies. Understanding these incentives is vital for academics, investors and corporate stakeholders who wish to properly infer the motivations underlying a firm’s financial reporting strategy.

Preliminary draft. Please do not quote.
1. INTRODUCTION

There is an increasing interest among academics, regulators, shareholders and other stakeholders in examining the reporting incentives generated by concern for corporate social responsibility (CSR). Although CSR disclosure is voluntary in most countries, KPMG (2013) suggests that the reporting of CSR initiatives is now a common practice worldwide. Due to the increase in CSR disclosures, researchers are increasingly concerned about the antecedents and consequences of CSR reporting (e.g., Dhaliwal et al. 2011; Kim et al. 2012; Lanis and Richardson 2012; Pyo and Lee 2013). Recent studies demonstrate that firms can benefit in several ways from issuing reports of their CSR activities. For example, Dhaliwal et al. (2011; 2012) find that firms which provide standalone CSR reports have lower costs of capital and fewer analyst forecast errors. Institutional investors may also look for socially responsible firms to invest in because these firms are less likely to engage in earnings management and corporate tax avoidance (Kim et al. 2012; Hoi et al. 2013).

A number of research studies provide evidence on the ways that CSR affects management behaviour and decision making (e.g., Lanis and Richardson 2012; Kim et al. 2012; Hoi et al. 2013; Pyo and Lee 2013). However, none of these studies investigate the interplay between the CSR reporting incentives and other corporate reporting incentives (e.g., earnings prop-ups incentives) in determining management decisions. We argue that the ethical drive behind the reporting of CSR initiatives has an interactive or moderating role with other corporate incentives that affect a firm’s corporate strategies. Understanding these affects is important for enabling academics, investors and corporate stakeholders to properly infer the motivations and strategies underlying corporate reporting. Previous studies, however, have paid little or no attention to this concern.

This research fills a gap in the literature by investigating how differing reporting incentives interrelate in affecting corporate decisions to execute related party transactions.
(RPTs) in an emerging market, specifically in the Chinese market. We focus on RPTs to examine this issue because the volume of RPTs is very significant in both Western and Asian countries (CFA Institute 2007; Gordon et al. 2007; OECD 2009). RPTs are especially substantial in emerging markets and Asian countries such as China. The OECD (2012) finds that 53 percent of Chinese listed companies report significant RPTs (having more than 1 percent of revenue). Based on a sample of 2,771 firm-year observations that have RPTs over the period of 2008-2012, we hypothesize and find that Chinese firms having higher CSR initiatives and tunneling incentives have higher amount of abnormal RPTs, and this suggests that they are more likely to divert profits to their parent companies via RPTs.

These findings imply that ethical incentives should be taken into account when assessing a firm’s reporting behaviour. Our study that examines the interplay of incentives between a firm’s CSR reporting initiatives and its various other reporting incentives enhances our understanding of the ways that firms devise their business policies. Interpreting our results helps regulators and other market participants in recognising the potential effects that can arise from CSR reporting incentives.

Our paper is organized as follows. Section 2 reviews literature and develops our hypothesis. Section 3 discusses the research methodology while Section 4 presents our empirical findings. We conclude in Section 5.

2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

CSR refers to the corporate obligation to meet society’s economic, legal, ethical and discretionary expectations (Carroll 1979). Beyond legal compliance, listed firms are expected to ‘do the right things’ by addressing the stakeholders’ needs. If the general public perceives that a firm’s behaviour does not conform to its expectations, social contracts are ‘revoked’, and the responses of stakeholders can be hostile (Deegan 2002). As the survival of a firm rests
on the support of its stakeholders, firms should take remedial action to repair any gap in legitimacy between changing social norms and the firms’ operations (Deegan 2002). Taking initiative to report CSR-related activities seems to address this concern. Recent studies also reveal that firms with significant CSR initiatives are associated with better long-term financial performance (Chen and Wang 2011), lower costs of capital (Dhaliwal et al. 2011), more favourable public image (Qu 2007) and even increased benefits for management (Hemingway and Maclagan 2004).

RPT is one major type of business transactions and commonly used in corporate groups with complicated structures. Although RPT is a legitimate business practice in both developed and developing economies, this form of transaction can also be used for personal gain or for diverting profits away from minority shareholders (OECD 2009). A number of recent well-publicised accounting scandals in the US (such as the Enron failure or the Tyco scandal) and several cases of fraudulent reporting in China (such as the Shanghai Pharma and the Greencool cases) reveal that many firms manage profits opportunistically via RPTs. The complicated nature of RPTs also hinders financial statement users from properly interpreting firm value (Wong et al. 2015). Therefore, investors and other stakeholders are increasingly concerned over the possible abuse of RPTs (Gordon et al. 2007; OECD 2009).

**CSR reporting incentives versus tunneling incentives**

Prior studies show that Chinese firms are likely to tunnel profits away from their listed entities to support their unlisted non-profitable units via RPTs (Peng et al. 2011; Lo et al. 2010a; Aharony et al. 2010; Jian and Wong 2010). For example, Aharony et al. (2010) reveal that listed companies tunnel profits via RPTs in their post-IPO period to offset profits that were propped up in their pre-IPO period. Such tunneling activities mislead investors and help

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1. Companies can engage in various business activities among group-affiliated companies such as the purchase or sale of goods and services, the purchase or sale of assets or equity, and inter-company lending.
the controlling shareholders to camouflage their extraction of private control benefits from the outside minority shareholders, which usually involves losses for those minority shareholders (Liu and Lu 2007; Wong et al. 2015).

On the one hand, tunneling may hide the operating performance of a firm and expropriate minority shareholders’ wealth, which is socially irresponsible (Cheung et al. 2009). On the other hand, tunneling can help to subsidize a firm’s non-profit-making affiliates and enable various CSR initiatives (e.g., in fulfilling social obligations to workers and local communities), which is indeed socially responsible (Lo et al. 2010a). Although we note that the ethical perspectives on tunneling activities are complicated (and thus deserve thorough investigation), we take the view that firms with significant CSR initiatives are expected to be more ethical. We expect that these firms are less likely to tunnel profits out from the listed companies via RPTs. Therefore our next hypothesis is as follows.

**Hypothesis 1:** Firms with significant CSR initiatives are less likely to tunnel profits via related-party transactions.

### 3. RESEARCH METHODOLOGY

Since 2008, firms listed on the Shanghai Stock Exchange have been encouraged to disclose stand-alone CSR reports (Shanghai Stock Exchange 2008). This voluntary disclosure policy provides unique information for our analysis. Our initial sample includes all companies listed on the Shanghai Stock Exchange between 2008 and 2012, excluding

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2 The *Guideline on Listed Companies’ Environmental Information Disclosure* (Shanghai Stock Exchange 2008) encourages initiatives in occupational health and safety, public welfare programs, product quality, environmental protection to be properly incorporated in the CSR stand-alone reports. Items to be disclosed refer to (1) corporate vision/mission, corporate governance (for investors), anti-corruptions, and risk strategy, (2) CSR initiatives with descriptions, indicators and level of contributions (if any) that include (i) CSR initiatives for employees, (ii) environmental protection, and (iii) social welfare (consisting of donation to disaster/charity/poverty/education, corporate giving to build public infrastructures), (3) Social contribution per share, (4) Awards related to environmental conservation, (5) Adoption of Global reporting initiatives (GRI), and (6) Audit or unaudited of the CSR report.
financial institutions and utilities firms. Firms that do not practise RPTs are also excluded from our study. All of the relevant financial data concerning RPTs and related general information are collected from the China Stock Market and Accounting Research (CSMAR) related-party transaction and general research database. This process yields 2,771 firm-year observations for our analyses.

We use the following regression model to test our hypothesis:

\[
ABN_{\text{RPT}_t} = \alpha_0 + \alpha_1 \text{CSR}_t + \alpha_2 \text{TUNNEL}_t + \alpha_3 \text{CSR} \times \text{TUNNEL}_t + \alpha_4 \text{EM}_t + \alpha_5 \text{LEVERAGE}_t + \alpha_6 \text{GROWTH}_t + \alpha_7 \text{SIZE}_t + \alpha_8 \text{YEAR} + \alpha_9 \text{INDUSTRY} + \varepsilon
\]

The dependent variable, \(ABN_{\text{RPT}_t}\), represents the value of the abnormal portion of a firm’s RPTs. As intra-group transactions could be legitimate and purely business related, we capture a firm’s incentives for engaging in tunneling activities via abnormal RPTs. \(ABN_{\text{RPT}_t}\) represents the residual term obtained from the model of regressing the total RPTs on a firm’s financial leverage (\(\text{LEVERAGE}_t\); as measured by the total debt-to-asset ratio), firm size (\(\text{SIZE}_t\); as measured by the natural log of total assets), the firm’s growth (\(\text{GROWTH}_t\); as measured by its book-to-market equity ratio) and the industry fixed effects (Jian and Wong 2010).

We use \(\text{CSR}_t\) to capture the CSR reporting incentives for RPTs. In view of the absence of CSR scores in China, we use an indicator variable, \(\text{CSR}_t\), to proxy for the CSR reporting incentives in our model (Dhaliwal et al. 2012). \(\text{CSR}_t\) equals 1 if the concerned firm issues stand-alone CSR reports during the year, and 0 otherwise. Any significant coefficient on \(\text{CSR}_t\) in the models represents the influence of voluntary reporting of CSR initiatives on a firm’s RPTs.

We examine the trade-off between ethical incentives associated with CSR reporting and tunneling incentives. \(\text{TUNNEL}_t\) represents the tunneling incentives that arise from listed
spin-off firms. This variable equals 1 if the controlling shareholder of a firm is the Chinese government, and 0 otherwise. As Lo et al. (2010a) suggest, firms with high tunneling incentives are subject to more RPT manipulations, and we thus expect a positive coefficient on TUNNEL\textsubscript{t}. Our main variable of interest refers to CSR*\text{CSR}^{*}\text{TUNNEL}_{t}, and any significant coefficient on CSR*\text{TUNNEL}_{t} represents a significant effect of CSR initiatives on a firm’s tunneling activities via RPTs. We expect a negative coefficient on CSR*\text{TUNNEL}_{t} if the ethical incentives associated with CSR initiatives are more important and are able to constrain the firm’s tunneling practices.\textsuperscript{3}

Following prior studies on RPTs (e.g., Jian and Wong 2010; Lo et al. 2010a; 2010b), we include several control variables in the regression models. These variables are EM\textsubscript{t} (earnings management incentive that equals 1 if the firm’s current return on assets lies between 0.00 and 0.02; and 0 otherwise), LEVERAGE\textsubscript{t} (measured by the total debt-to-asset ratio), GROWTH\textsubscript{t} (measured by the book-to-market equity ratio), and SIZE\textsubscript{t} (measured by the natural log of total assets). In addition, we include (i) YEAR (year dummies) to control for the year effects and (ii) INDUSTRY (industry dummies) to control for industry effects. For this variable, we use the standard industry classifications compiled by the regulator of listed companies, the China Securities Regulatory Commission (CSRC).

4. EMPIRICAL FINDINGS

Regression results

Table 1 reports the regression results. We find that CSR\textsubscript{t} and ABN\_RPT\textsubscript{t} are negatively correlated at the 1\% level, suggesting that firms with higher CSR reporting incentives are less likely to engage in earnings management via RPTs. However, it is interesting to note that the interaction term of CSR\textsubscript{t} and TUNNEL\textsubscript{t} is positively significant at

\textsuperscript{3} We note, however, that a positive coefficient on CSR*\text{TUNNEL}_{t} may also give another aspect of management perceptions toward tunnelling practices that are initiated to support unlisted social units.
the 1% level, indicating that trade-offs between CSR incentives and other corporate reporting incentives exist among government-controlled firms. Since tunneling can help to subsidize a firm’s non-profit-making affiliates and enable various CSR initiatives (e.g., in fulfilling social obligations to workers and local communities), CSR firms are thus more likely to tunnel profits when they have a high tunneling incentive. Therefore, the ethical drive for CSR reporting plays a prominent role in rationalization the tunneling activities via RPTs.

Table 1. Least Square Regression Results

| Whole sample (n=2,771); Dependent Variable = ABN_RPT |
|-----------------|-----------------|-----------------|
| Variable        | Coefficient     | Standard Error  | Z-value |
| Intercept       | 63.653          | 9.312           | 6.84*** |
| CSR             | -3.309          | 0.806           | -4.10***|
| TUNNEL          | -4.007          | 0.889           | -4.51***|
| CSR*TUNNEL      | 5.913           | 1.033           | 5.72*** |
| EM              | -0.497          | 0.389           | -1.28   |
| LEVERAGE        | 4.772           | 3.787           | 1.26    |
| GROWTH          | 2.335           | 1.562           | 1.49    |
| SIZE            | -2.857          | 0.444           | -6.43***|
| YEAR            | YES             |                 |         |
| INDUSTRY        | YES             |                 |         |
| Adjusted R square | 0.142         |                 |         |
| F statistic     | 22.853          |                 |         |

**Variables Definition**

- **ABN_RPT** = Residual term obtained from the model of regressing the total RPTs on LEVERAGE, SIZE, GROWTH and the industry fixed effects
- **CSR** = 1 if the firm issues stand-alone CSR reports during the year; and 0 otherwise
- **TUNNEL** = 1 if the controlling shareholder of the firm is the Chinese government; and 0 otherwise
- **CSR*TUNNEL** = Interaction term of CSR and TUNNEL
- **EM** = 1 if the firm’s current return on asset lies between 0.00 and 0.02; and 0 otherwise
- **LEVERAGE** = Total debt over total assets of the firm
- **GROWTH** = Book-to-market equity ratio of the firm
- **SIZE** = Natural log of total assets of the firm

***statistically significant at the 1% level
5. CONCLUSIONS

Recent studies provide evidence on how CSR initiatives affect management behaviour and decision making (e.g., Kim et al. 2012; Hoi et al. 2013; Pyo and Lee 2013). However, none of these studies examine the interplay between CSR reporting incentives (i.e., ethical incentives) and other corporate reporting incentives (e.g., earnings management or tax avoidance incentives) in shaping management decisions, and particularly, for the transactions between related enterprises. We argue that the ethical drive for reporting on CSR initiatives has an interactive or moderating role with other corporate reporting incentives, and that these various incentives affect a firm’s corporate strategies. Understanding these incentives is vital for academics, investors and corporate stakeholders who wish to properly infer the motivations underlying a firm’s financial reporting strategy. Previous studies, however, have paid little or no attention to this issue.
REFERENCES


